S. HRG. 99-246, Pt. II

TAX REFORM PROPOSALS—II

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JUNE 12, 1985

(TESTIMONY OF ROSCOE L. EGGER, JR.)

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TAX REFORM PROPOSALS—II

WEDNESDAY, JUNE 12, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Chafee, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, Bradley, and Mitchell.

[The press release announcing the hearing follows:]

[Press release No. 85-033, May 30, 1985]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, travelling in Oregon, today announced that the Committee will begin hearings in early June on President Reagan's tax reform proposal.

"The Committee's work on the President's proposal will begin with Treasury Secretary Baker's testimony on June 11th," said the chairman of the Senate tax-writing committee, "and will involve upwards of 30 days of hearings—3 or 4 days each week the Senate is in session during the months of June, July and September."

Chairman Packwood announced the first five days of hearings, as follows:

Secretary of the Treasury James A. Baker III will present the President's tax plan to the Committee on Tuesday, June 11, 1985.

Internal Revenue Service Commissioner Roscoe Egger will appear before the Committee to testify on Wednesday, June 12, 1985.

On Thursday, June 13, 1985, the Committee will receive testimony from invited national business leaders.

On Monday, June 17th, public witnesses will testify on the impact of the tax reform proposal on people below the poverty line.

On Tuesday, June 18, witnesses invited by the Committee will discuss the general issue of whether corporations ought to pay a higher percentage of the income tax burden.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. The hearing will come to order, please.

Mr. Commissioner, welcome. We are glad to have you here. I have read your full statement and will put it in the record. We would appreciate it if you would abbreviate what you want to say so we can ask you some questions. Go right ahead.

STATEMENT OF THE HONORABLE ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE, WASHINGTON, DC

Commissioner EGGER. I am pleased to be here with you today, Mr. Chairman, to discuss the tax administration aspects of the President's tax reform proposal. I am here in strong support of fundamental tax reform as reflected in these proposals.

In just over 4 years as Commissioner, I have testified before committees of Congress on nearly 60 occasions; this time it is different. This time the Congress is facing an unprecedented opportunity to make the tax system fairer, simpler, and more efficient. I am here to urge you to make the most of this opportunity.

Perhaps the strongest argument for tax reform is that too many Americans believe the tax system is unfair. Unfortunately, the Internal Revenue Code gives them grounds for this belief.

The current Code has been built around tax breaks for special purposes and special interests. It is filled with features attempting to further many admittedly desirable social, economic, or other objectives, but the system has become overwhelmed by these special interest provisions. The system has become overly complex, unwieldly, and difficult to administer.

Our tax system is based on the theory and practice of voluntary compliance. While the tax enforcement activities of the IRS are important and necessary, these efforts pale in comparison to our reliance on taxpayers' voluntary self-assessment of tax liability. The willingness of Americans to voluntarily report their tax liability is the key to the administration of taxes in our free society.

Because we believe that there may be a link between taxpayer attitudes toward the system and voluntary compliance levels, in 1984 the Service contracted with a public opinion research firm to examine taxpayer attitudes. The results showed some perceptions of the tax system that were extremely disturbing. For example: 80 percent believe the Federal tax system benefits the rich and is unfair to the ordinary working person; a majority felt that cheating is on the rise and that more than 25 percent of taxpayers cheat; about 20 percent of the respondents admitted cheating on their own returns.

Perceptions of fairness of a tax system are important for two main reasons. First, as recipients of the public's trust, you in the Congress and we in the executive branch have an obligation to assure that our laws are made and enforced consistent with principles of fairness. Second, as a tax administrator, I have a particular interest in fairness. If the tax laws are considered to be unfair, I believe that compliance with the tax laws will deteriorate.

In the analysis of the fairness of any tax system, perhaps the most important element is horizontal equity. The concept of horizontal equity is a simple one: that persons with about the same income pay about the same amount of tax.

Under this test, our present tax system fails. The complex array of provisions now in the code results in taxpayers with the same real incomes paying widely differing amounts of tax. The system produces similarly distorted results with respect to the income of corporations.

Let me give you a few examples of how the present system violates the principles of horizontal equity.

When the current ACRS system is combined with the investment tax credit, with other credits, and the existing rules on deductibility of interest, the result is a distorted front loading of tax benefits. That is, investments are designed to carry with them tremendous tax benefits in the first few years of the life of the investment assets involved.

The front loading of tax shelter investments permits high income taxpayers to substantially reduce or eliminate their tax liability. And in the case of most real estate transactions, losses resulting in deductions may be incurred without personal liability to pay the amounts that form the basis for the deductions claimed.

One measure of tax shelter activity is the level of participation in limited partnerships. The limited partnership form is a favored device for structuring tax shelter investments. Over the time period from 1979 to 1982, the number of partnerships other than limited partnerships increased by 11 percent, and the number of partners in these partnerships increased by 9 percent; on the other hand, the number of limited partnerships increased 66 percent, and the number of partners increased 100 percent. While general partnerships continued to show net income during this time period, limited partnerships showed losses that increased from $5.7 billion in 1979 to $17.5 billion in 1982.

The President's proposals address the problem of tax shelters in a number of concrete ways:

First, the repeal of the investment tax credit. This is the lifeblood of many of our abusive tax shelters.

Second, the changes in depreciation rules.

Third, lower tax rates. The significance of tax shelter deductions would be reduced.

Fourth, limits on interest deductibility. The proposal's $5,000 cap on deductible interest, other than home mortgage interest, speaks directly to many tax shelter investments that are structured as limited partnerships.

Fifth, the extension of the "at risk" rule to real estate investments.

Finally, the repeal of a number of special credits.

The majority of taxpayers who do not live expense-account lives end up subsidizing a privileged group of executives and professionals who mix business activities with entertainment. The unfairness inherent in existing law is obvious to individuals who pay for meals and entertainment with their own after-tax dollars.

By the use of trusts and other complex arrangements, some well-advised taxpayers have been able to shift income from their high tax brackets to their children's or the trust's low-marginal tax rate.

These are just a few examples of how the present system violates basic principles of fairness.

In addition to the decline in public confidence in the system, our research indicates that there are disturbing trends in the actual levels of compliance.

Our research indicates that the level of voluntary compliance is declining. In fiscal year 1974 we estimate that taxpayers voluntarily paid 84 percent of their total tax liability. By fiscal year 1980, the percentage of voluntary payment had fallen to 82.1 percent. Even counting the additional revenue that we expect to collect as a result of the compliance provisions in the Tax Equity and Fiscal Responsibility Act of 1982, our current estimates indicate that the percentage of voluntary compliance will fall to 81.6 percent by fiscal year 1986. In order to appreciate the implications of this drop in voluntary compliance, consider the fact that a 1 percent reduc-

tion in the level of compliance results in a revenue loss of $5 billion.

The tax gap is the amount of income tax which individuals and corporations owe but do not voluntarily pay. In 1983 the IRS published estimates of the size of this gap. Looking at the legal sector only—that is, not including the tax gap associated with criminal activities such as drug trafficking, et cetera—the gap grew from $29 billion in fiscal year 1974 to $62 billion in fiscal year 1980. We project that the legal sector gap will reach about $92 billion by fiscal year 1986.

Beyond the statistics on compliance levels there are several other disturbing trends.

One, the volume and the scope of recent tax legislation has made the law more complex and difficult to administer. The Deficit Reduction Act of 1984 was the 19th major legislative change in the tax laws in 22 years. Some raised taxes, some lowered taxes, and some even claimed that they simplified taxes. In sum, the flood of recent legislation has made the tax system a vastly complicated moving target.

The pace of recent tax legislation means that the Service must administer not one but a multitude of different Internal Revenue Codes. For each new change in the law, the Internal Revenue Service must make corresponding changes in our tax processing system and our various compliance programs. We prepare computer programs for next year's law, we write regulations for this year's law, and we audit returns based on last year's law, and the year before that, and so on.

Two, while some taxpayers will always need professional assistance in preparing their returns, a properly functioning tax system should permit average taxpayers to prepare their own return. However, our preliminary data for 1985 indicates that some 44 percent of all taxpayers are using paid preparers. This is up from 37 percent just 3 years ago. Further, almost two-thirds of this year's 1040, or long form filers, hired preparers. This amounts to nearly a 15 percent increase from last year. Despite all our efforts to simplify filing requirements, more than 600,000 taxpayers were so intimidated by the complexity of the system that they hired preparers to file returns that could be done on our most basic form, the Form 1040EZ.

Three, the essentially annual tradition of major tax legislation has created delays in providing regulatory guidance to taxpayers. It should not be surprising that we are not yet close to the midway point of publishing the 175 regulation projects associated with the 1984 Act. Also, there are still projects pending from the 1976 tax law.

Four, one of the most disturbing trends is an increase in participation in abusive tax shelters by moderate income people. Abusive tax shelters are a problem wherever they occur, but they are particularly offensive when unscrupulous promoters prey on the lack of sophistication and, yes, the greed of some moderate income people.

Recently, I reviewed a number of returns that showed evidence of abusive shelters marketed to moderate income individuals. In one case an individual with just over $20,000 of income claimed

over $30,000 of artificial losses. In another case a couple with combined earnings of slightly over $30,000 became involved in an abusive leasing scheme. When the couple filed a claim for refund based on the tax shelter benefits, we refunded approximately $11,000. After examination, we disallowed the shelter benefits and presented the taxpayer with a bill for more than $16,000 of tax, penalties, and interest. A third case involved a couple with about $40,000 of income. Again, we refunded about $13,000 in tax. After audit, we presented the taxpayer with a bill for more than $19,000.

Perhaps the saddest part of these stories is that these taxpayers generally do not have the financial resources to pay this tax, penalty, and interest. The tax obligations that have resulted will become a financial burden for these individuals for years to come.

There is one additional finding of the taxpayer attitude survey that I would like to mention, that I strongly agree with as well: 9 out of 10 individuals felt that simplifying the whole tax collection system would help the IRS collect tax moneys owed.

Since tax administration is our professional life, we at the Service have a strong personal interest in tax reform. Despite the fact that our efforts will always be viewed by some as insufficient, we believe significant progress has been made by the Service in the past couple of years in simplifying the problems taxpayers face in dealing with the tax administration system. However, these advances are minor compared to the opportunitity presented to you by the President's proposal.

It is easy to overlook one important fact here: Both the taxpayers and the Internal Revenue Service have an interest in fairness and simplification. To the extent that we can make the system fairer to taxpayers, we can simplify our job of administering it. For example, if we can reduce the burden on individuals by simplifying the number of people that have to file or by simplifying the returns that are filed, we will have certainly eased the burden on both the individuals and the Service.

The President's proposal would have numerous far-ranging simplification and fairness effects. For example:

Twenty-five percent of those who now itemize their deductions will no longer need to itemize. The total number of itemizers would drop from about 37 million to around 25 million.

Approximately 3 million families at or near the poverty line will receive the most significant simplification of all, elimination of their income tax liability. The increased zero-bracket amount and personal exemptions will zero out income tax liability for these families.

The President's proposal will eliminate many tax forms and schedules and ultimately will eliminate the need for untold pages of rulings and regulations.

In a number of respects the proposal reduces the opportunity for complex tax planning. Thus, the plan will enable people to arrange their affairs in simpler and more sensible ways.

One simplification-oriented aspect of the reform proposal is of special to the IRS—that is a "return free" tax system.

The concept of a tax system where most taxpayers do not file a return is not new and would not be unique to the United States.

Other countries such as Japan and the United Kingdom have systems in place that spare wage earners from filing returns.

One of the major and most obvious motivations for a return-free system is the extensive third-party data IRS already receives. Through the reporting of income via the W-2's and information documents such as 1099's, the IRS has the information capability to prepare returns for a majority of taxpayers.

The move to a return-free system will require that the IRS process all available information documents within the first 3 months following the close of a tax year. This acceleration of the processing of documents will have valuable spinoff effects for our existing information document matching program. In particular, the timely processing of documents will enable the Service to propose adjustments to returns on a more current basis. The more timely availability of information will be beneficial to both the Service and the taxpayers.

Beginning with a pilot program, the IRS would focus predominately on the Form 1040EZ filing population. These are single individuals with no dependents, limited interest income, and who earn under $50,000. Based on our 1983 figures, if we begin the program in 1987 or 1988, it would apply to about 21 million taxpayers, or roughly one-fifth of the total. By the early 1990's, the program could reach more than 50 percent of the individual taxpayers. In other words, by then more than half the taxpayers would never have to wrestle with the tax return again. By the early 1990's, these taxpayers would be spared 71 million hours of actual return preparation time and untold amounts in preparers' fees, not to mention considerable aggravation. We think the return-free system proposal merits serious consideration as part of our overall reform plan.

Mr. Chairman, as I have said, the present system continues to work, but the strains on the system are beginning to show. Fundamental tax reform is long overdue.

Fairness and simplicity are key to the proper functioning of a voluntary compliance system. Our current tax system needs both. The President's tax plan takes significant strides toward addressing the most troubling aspects of the current law. In addition, the proposal makes dramatic reductions in marginal rates. These changes will significantly enhance the operation of the tax administration system. Taxes will be fairer, they will be easier to collect, and millions of people will be spared the drudgery of preparing and filing tax returns.

Mr. Chairman, in my more than 35 years of experience with the tax system in both public and private life, I have not seen a better opportunity for fundamental tax reform. I hope we do not miss this historic opportunity.

Thank you.

[Commissioner Egger's written statement follows:]

STATEMENT OF
ROSCOE L. EGGER, JR.
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
SENATE FINANCE COMMITTEE

JUNE 12, 1985

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM PLEASED TO BE WITH YOU TODAY TO DISCUSS THE TAX ADMINISTRATION ASPECTS OF THE PRESIDENT'S TAX REFORM PROPOSALS. I AM HERE IN STRONG SUPPORT OF THE FUNDAMENTAL TAX REFORM REFLECTED IN THE PRESIDENT'S PROPOSALS.

IN MY SLIGHTLY MORE THAN FOUR YEARS AS COMMISSIONER, I HAVE TESTIFIED BEFORE COMMITTEES OF CONGRESS ON NEARLY 60 OCCASIONS, BUT THIS TIME IS DIFFERENT. THIS TIME THE CONGRESS IS FACING AN UNPRECEDENTED OPPORTUNITY TO MAKE THE TAX SYSTEM FAIRER, SIMPLER, AND MORE EFFICIENT. I AM HERE TO URGE YOU TO MAKE THE MOST OF THIS OPPORTUNITY.

PERHAPS THE STRONGEST ARGUMENT FOR TAX REFORM IS THAT TOO MANY AMERICANS BELIEVE THE TAX SYSTEM IS UNFAIR. UNFORTUNATELY, THE INTERNAL REVENUE CODE GIVES THEM GROUNDS FOR THIS BELIEF.

THE CURRENT CODE HAS BEEN BUILT AROUND TAX BREAKS FOR SPECIAL PURPOSES AND SPECIAL INTERESTS. IT IS FILLED WITH FEATURES ATTEMPTING TO FURTHER MANY ADMITTEDLY DESIRABLE SOCIAL, ECONOMIC OR OTHER OBJECTIVES, BUT THE SYSTEM HAS BECOME OVERWHELMED BY THESE SPECIAL INTEREST PROVISIONS. THE SYSTEM HAS BECOME OVERLY COMPLEX, UNWIELDLY, AND DIFFICULT TO ADMINISTER.

WHY DO WE NEED TAX REFORM?

OUR TAX SYSTEM IS BASED ON THE THEORY AND PRACTICE OF VOLUNTARY COMPLIANCE. WHILE THE TAX ENFORCEMENT ACTIVITIES OF THE IRS ARE IMPORTANT AND NECESSARY, THESE EFFORTS PALE IN COMPARISON TO OUR RELIANCE ON TAXPAYERS' VOLUNTARY SELF-ASSESSMENT OF TAX LIABILITY. THE WILLINGNESS OF AMERICANS TO VOLUNTARILY REPORT THEIR TAX LIABILITY IS THE KEY TO THE ADMINISTRATION OF TAXES IN OUR FREE SOCIETY.

BECAUSE WE BELIEVE THAT THERE MAY BE A LINK BETWEEN TAXPAYER ATTITUDES TOWARD THE SYSTEM AND THE VOLUNTARY COMPLIANCE LEVELS, IN 1984 THE SERVICE CONTRACTED WITH A PUBLIC OPINION RESEARCH FIRM TO EXAMINE TAXPAYER ATTITUDES. THE RESULTS SHOWED SOME PERCEPTIONS OF THE TAX SYSTEM THAT WERE EXTREMELY DISTURBING. FOR EXAMPLE:

-- 80% BELIEVE THE FEDERAL TAX SYSTEM BENEFITS THE RICH AND IS UNFAIR TO THE ORDINARY WORKING PERSON.

-- A MAJORITY FELT THAT CHEATING IS ON THE RISE AND THAT MORE THAN 25% OF TAXPAYERS CHEAT.

-- ABOUT 20% OF THE RESPONDENTS ADMITTED CHEATING ON THEIR OWN RETURNS.

PERCEPTIONS OF FAIRNESS OF A TAX SYSTEM ARE IMPORTANT FOR TWO MAIN REASONS. FIRST, AS RECEPIENTS OF THE PUBLIC'S TRUST YOU IN THE CONGRESS AND WE IN THE EXECUTIVE BRANCH HAVE AN OBLIGATION TO ASSURE THAT OUR LAWS ARE MADE AND ENFORCED CONSISTENT WITH PRINCIPLES OF FAIRNESS. SECOND, AS A TAX ADMINISTRATOR I HAVE A PARTICULAR INTEREST IN FAIRNESS. IF TAX LAWS ARE CONSIDERED TO BE UNFAIR, I BELIEVE THAT COMPLIANCE WITH THE TAX LAWS WILL DETERIORATE.

HORIZONTAL EQUITY

IN THE ANALYSIS OF THE "FAIRNESS" OF ANY TAX SYSTEM, PERHAPS THE MOST IMPORTANT ELEMENT IS HORIZONTAL EQUITY. THE CONCEPT OF HORIZONTAL EQUITY IS A SIMPLE ONE: THAT PERSONS WITH ABOUT THE SAME INCOME PAY ABOUT THE SAME AMOUNT OF TAX.

UNDER THIS TEST OUR PRESENT TAX SYSTEM FAILS. THE COMPLEX ARRAY OF PROVISIONS NOW IN THE CODE RESULTS IN TAXPAYERS WITH THE SAME REAL INCOMES PAYING WIDELY DIFFERING AMOUNTS OF TAX. THE SYSTEM PRODUCES SIMILARLY DISTORTED RESULTS WITH RESPECT TO THE INCOME OF CORPORATIONS.

LET ME GIVE YOU A FEW EXAMPLES OF HOW THE PRESENT SYSTEM VIOLATES THE PRINCIPLES OF HORIZONTAL EQUITY.

--TAX SHELTERS - WHEN THE CURRENT ACRS SYSTEM IS COMBINED WITH THE INVESTMENT TAX CREDIT, OTHER CREDITS, AND THE EXISTING RULES ON DEDUCTIBILTY OF INTEREST, THE RESULT IS A DISTORTED "FRONT-LOADING" OF TAX BENEFITS. THAT IS, INVESTMENTS ARE DESIGNED TO CARRY WITH THEM TREMENDOUS TAX BENEFITS IN THE FIRST FEW YEARS OF THE LIFE OF THE INVESTMENT ASSETS INVOLVED.

THE "FRONT-LOADING" OF TAX SHELTER INVESTMENTS PERMITS HIGH INCOME TAXPAYERS TO SUBSTANTIALLY REDUCE OR ELIMINATE THEIR TAX LIABILITY. AND, IN THE CASE OF MOST REAL ESTATE TRANSACTIONS, LOSSES RESULTING IN DEDUCTIONS MAY BE INCURRED WITHOUT PERSONAL LIABILITY TO PAY THE AMOUNTS THAT FORM THE BASIS FOR THE DEDUCTIONS CLAIMED.

ONE MEASURE OF TAX SHELTER ACTIVITY IS THE LEVEL OF PARTICIPATION IN LIMITED PARTNERSHIPS. THE LIMITED PARTNERSHIP FORM IS A FAVORED DEVICE FOR STRUCTURING TAX SHELTER INVESTMENTS. OVER THE TIME PERIOD FROM 1979 TO 1982, THE NUMBER OF PARTNERSHIPS OTHER THAN LIMITED PARTNERSHIPS INCREASED BY 11% AND THE NUMBER OF PARTNERS IN THESE PARTNERSHIPS INCREASED BY 9%. ON THE OTHER HAND, THE NUMBER OF LIMITED PARTNERSHIPS INCREASED 66% AND THE NUMBER OF PARTNERS INCREASED 100%. WHILE GENERAL PARTNERSHIPS CONTINUED TO SHOW NET INCOME DURING THIS TIME PERIOD, LIMITED PARTNERSHIPS SHOWED LOSSES THAT INCREASED FROM $5.7 BILLION IN 1979 TO $17.5 BILLION IN 1982.

THE PRESIDENT'S PROPOSALS ADDRESS THE PROBLEM OF TAX SHELTERS IN A NUMBER OF CONCRETE WAYS.

1) FIRST AND FOREMOST, THE REPEAL OF THE INVESTMENT TAX CREDIT -- THE LIFEBLOOD OF MANY ABUSIVE SHELTERS.

2) SECOND, THE CHANGES IN DEPRECIATION RULES.

3) THIRD, LOWER TAX RATES. THE SIGNIFICANCE OF TAX SHELTER DEDUCTIONS WOULD BE REDUCED.

4) LIMITS ON INTEREST DEDUCTIBILITY. THE PROPOSAL'S $5,000 CAP ON DEDUCTIBLE INTEREST (EXCLUDING MORTGAGE INTEREST) SPEAKS DIRECTLY TO MANY TAX SHELTER INVESTMENTS THAT ARE STRUCTURED AS LIMITED PARTNERSHIPS.

5) EXTENSION OF THE "AT RISK" RULE TO REAL ESTATE.

6) FINALLY, THE REPEAL OF A NUMBER OF SPECIAL CREDITS.

-- Entertainment Expenses - THE MAJORITY OF TAXPAYERS WHO DO NOT LIVE EXPENSE ACCOUNT LIVES END UP SUBSIDIZING A PRIVILEGED GROUP OF EXECUTIVES AND PROFESSIONALS WHO MIX BUSINESS ACTIVITIES WITH ENTERTAINMENT. THE UNFAIRNESS INHERENT IN EXISTING LAW IS OBVIOUS TO INDIVIDUALS THAT PAY FOR MEALS AND ENTERTAINMENT WITH THEIR OWN AFTER-TAX DOLLARS.

-- Income Shifting - BY THE USE OF TRUSTS AND OTHER COMPLEX ARRANGEMENTS, SOME WELL ADVISED TAXPAYERS HAVE BEEN ABLE TO SHIFT INCOME FROM THEIR HIGH TAX BRACKETS TO THEIR CHILDREN'S OR THE TRUSTS' LOW MARGINAL TAX RATE.

THESE ARE JUST A FEW EXAMPLES OF HOW THE PRESENT SYSTEM VIOLATES BASIC PRINCIPLES OF FAIRNESS.

TRENDS IN COMPLIANCE AND TAX ADMINISTRATION

IN ADDITION TO THE DECLINE IN PUBLIC CONFIDENCE IN THE SYSTEM, OUR RESEARCH INDICATES THAT THERE ARE DISTURBING TRENDS IN THE ACTUAL LEVELS OF COMPLIANCE.

OUR RESEARCH INDICATES THAT THE LEVEL OF VOLUNTARY COMPLIANCE IS DECLINING. IN FISCAL YEAR 1974, WE ESTIMATE THAT TAXPAYERS VOLUNTARILY PAID 84% OF THEIR TOTAL INCOME TAX LIABILITY. BY FISCAL YEAR 1980, THE PERCENTAGE OF VOLUNTARY PAYMENT HAD FALLEN TO 82.1%. EVEN COUNTING THE ADDITIONAL REVENUE THAT WE EXPECT TO COLLECT AS A RESULT OF THE COMPLIANCE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, OUR CURRENT ESTIMATES INDICATE THAT THE PERCENTAGE OF VOLUNTARY COMPLIANCE WILL FALL TO 81.6% BY FISCAL YEAR 1986. IN ORDER TO APPRECIATE THE IMPLICATIONS OF THIS DROP IN VOLUNTARY COMPLIANCE, CONSIDER THE FACT THAT A 1% REDUCTION IN THE LEVEL OF COMPLIANCE RESULTS IN A REVENUE LOSS OF $5 BILLION.

THE TAX GAP IS THE AMOUNT OF INCOME TAX WHICH INDIVIDUALS AND CORPORATIONS OWE BUT DO NOT VOLUNTARILY PAY. IN 1983 IRS PUBLISHED ESTIMATES OF THE SIZE OF THIS GAP. LOOKING AT THE LEGAL SECTOR ONLY -- THAT IS, NOT INCLUDING THE TAX GAP ASSOCIATED WITH CRIMINAL ACTIVITIES LIKE DRUG TRAFFICKING, GAMBLING, OR PROSTITUTION -- THE GAP GREW FROM $29 BILLION IN FISCAL YEAR 1974 TO $62 BILLION IN FISCAL YEAR 1980. WE PROJECT THAT THE LEGAL SECTOR GAP WILL REACH $92 BILLION BY FISCAL YEAR 1986.

BEYOND THE STATISTICS ON COMPLIANCE LEVELS THERE ARE SEVERAL OTHER DISTURBING TRENDS.

1. THE VOLUME AND SCOPE OF RECENT TAX LEGISLATION HAS MADE THE LAW MORE COMPLEX AND DIFFICULT TO ADMINISTER. THE DEFICIT REDUCTION ACT OF 1984 WAS THE 19TH MAJOR LEGISLATIVE CHANGE IN THE TAX LAWS IN 22 YEARS. SOME RAISED TAXES, SOME LOWERED TAXES, AND SOME EVEN CLAIMED THAT THEY SIMPLIFIED TAXES. IN SUM, THE FLOOD OF RECENT LEGISLATION HAS MADE THE TAX SYSTEM A VASTLY COMPLICATED MOVING TARGET.

THE PACE OF RECENT TAX LEGISLATION MEANS THAT THE SERVICE MUST ADMINISTER NOT ONE BUT A MULTITUDE OF DIFFERENT INTERNAL REVENUE CODES. FOR EACH NEW CHANGE IN THE LAW THE INTERNAL REVENUE SERVICE MUST MAKE CORRESPONDING CHANGES IN OUR TAX PROCESSING SYSTEM AND OUR VARIOUS COMPLIANCE PROGRAMS. WE PREPARE COMPUTER PROGRAMS FOR NEXT YEAR'S LAW, WE WRITE REGULATIONS FOR THIS YEAR'S LAW, AND WE AUDIT RETURNS BASED ON LAST YEAR'S LAW, THE YEAR BEFORE THAT, AND SO ON.

2. MORE TAXPAYERS ARE USING TAX PREPARERS. WHILE SOME TAXPAYERS WILL ALWAYS NEED PROFESSIONAL ASSISTANCE IN PREPARING THEIR RETURNS, A PROPERLY FUNCTIONING TAX SYSTEM SHOULD PERMIT AVERAGE TAXPAYERS TO PREPARE THEIR OWN RETURN. HOWEVER, OUR PRELIMINARY DATA FOR 1985 INDICATES THAT SOME 44% OF ALL TAXPAYERS ARE USING PAID PREPARERS., THIS IS UP FROM 37% JUST THREE YEARS AGO. ALMOST TWO-THIRDS OF THIS YEAR'S 1040 "LONG FORM" FILERS HIRED PREPARERS. THIS AMOUNTS TO NEARLY A 15% INCREASE FROM LAST YEAR. DESPITE ALL OUR EFFORTS TO SIMPLIFY FILING REQUIREMENTS, MORE THAN 600,000 TAXPAYERS WERE SO INTIMIDATED BY THE COMPLEXITY OF THE SYSTEM THAT THEY HIRED PREPARERS TO FILE RETURNS THAT COULD BE DONE ON OUR MOST BASIC FORM, THE FORM 1040EZ.

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3. The Service Cannot Meet the Demands for Regulatory Guidance. The essentially annual tradition of major tax legislation has created delays in providing regulatory guidance to taxpayers. It should not be surprising that we are not yet close to the mid-way point of publishing the 175 regulation projects associated with the 1984 Act. Also there are still projects pending from the 1976 tax law.

4. Participation in Abusive Tax Shelters is Moving Into Lower Income Groups. One of the most disturbing trends is an increase in participation in abusive tax shelters by moderate income people. Abusive tax shelters are a problem wherever they occur, but they are particularly offensive when unscrupulous promoters prey on the lack of sophistication, and yes, the greed of some moderate income people.

Recently, I reviewed a number of returns that showed evidence of abusive shelters marketed to moderate income individuals. In one case an individual with just over $20,000 of income claimed over $30,000 of artificial losses. In another case a couple with combined earnings of slightly over $30,000 became involved in an abusive leasing scheme. When the couple filed a claim for refund based on the tax shelter benefits, we refunded approximately $11,000. After examination we disallowed the shelter benefits and presented the taxpayer with a bill for more than $16,000 of tax, penalty and interest. A third case involved a couple with approximately $40,000 of income. Again, we refunded approximately $13,000 in tax. After audit we presented the taxpayer with a bill for more than $19,000.

PERHAPS THE SADDEST PART OF THESE STORIES IS THAT THESE TAXPAYERS GENERALLY DO NOT HAVE THE FINANCIAL RESOURCES TO PAY THE TAX, PENALTY AND INTEREST. THE TAX OBLIGATIONS THAT HAVE RESULTED WILL BE A FINANCIAL BURDEN FOR THESE INDIVIDUALS FOR YEARS TO COME.

Tax Reform and the IRS

THERE IS ONE ADDITIONAL FINDING OF THE TAXPAYER ATTITUDE STUDY THAT I WOULD LIKE TO MENTION, AND ONE THAT I STRONGLY AGREE WITH: NINE OUT OF TEN INDIVIDUALS FELT THAT SIMPLIFYING THE WHOLE TAX COLLECTION SYSTEM WOULD HELP IRS COLLECT TAX MONIES OWED.

SINCE TAX ADMINISTRATION IS OUR PROFESSIONAL LIFE, WE AT THE SERVICE HAVE A STRONG PERSONAL INTEREST IN TAX REFORM. DESPITE THE FACT THAT OUR EFFORTS WILL ALWAYS BE VIEWED BY SOME AS INSUFFICIENT, WE BELIEVE SIGNIFICANT PROGRESS HAS BEEN MADE BY THE SERVICE IN THE PAST COUPLE OF YEARS IN SIMPLIFYING THE PROBLEMS TAXPAYERS FACE IN DEALING WITH THE TAX ADMINISTRATION SYSTEM. HOWEVER, THESE ADVANCES ARE MINOR COMPARED TO THE OPPORTUNITY PRESENTED TO YOU BY THE PRESIDENT'S PROPOSAL.

IT IS EASY TO OVERLOOK ONE IMPORTANT FACT HERE -- BOTH TAXPAYERS AND THE SERVICE HAVE AN INTEREST IN FAIRNESS AND SIMPLIFICATION. TO THE EXTENT THAT WE CAN MAKE THE SYSTEM FAIRER TO TAXPAYERS, WE CAN SIMPLIFY OUR JOB OF ADMINISTERING IT. FOR EXAMPLE, IF WE CAN REDUCE THE BURDEN ON INDIVIDUALS BY REDUCING THE NUMBER OF PEOPLE THAT HAVE TO FILE OR BY SIMPLIFYING THE RETURNS THAT ARE FILED, WE WILL HAVE EASED THE BURDEN ON BOTH INDIVIDUALS AND THE SERVICE.

Overview of Simplification Provisions

The President's proposal would have numerous far-ranging simplification and fairness effects. For example:

1. Twenty-five percent of those who now itemize their deductions will no longer need to itemize. The total number of itemizers will drop from about 37 million to 25 million.

2. Approximately three million families at or near the poverty line will receive the most significant simplification of all, elimination of income tax liability. The increased zero bracket amount and personal exemptions will "zero out" income tax liability for these families.

3. The President's proposal will eliminate many tax forms and schedules and ultimately will eliminate the need for untold pages of rulings and regulations.

4. In a number of respects, the proposal reduces the opportunity for complex tax planning. Thus, the plan will enable people to arrange their affairs in simpler and more sensible ways.

A RETURN-FREE TAX SYSTEM

ONE SIMPLIFICATION ORIENTED ASPECT OF THE REFORM PROPOSAL IS OF SPECIAL INTEREST TO THE IRS -- A "RETURN-FREE" TAX SYSTEM.

THE CONCEPT OF A TAX SYSTEM WHERE MOST TAXPAYERS DO NOT FILE A RETURN IS NOT NEW AND WOULD NOT BE UNIQUE TO THE UNITED STATES. OTHER COUNTRIES SUCH AS JAPAN AND THE UNITED KINGDOM HAVE SYSTEMS IN PLACE THAT SPARE WAGE EARNERS FROM FILING TAX RETURNS.

ONE OF THE MAJOR -- AND MOST OBVIOUS -- MOTIVATIONS FOR A RETURN-FREE SYSTEM IS THE EXTENSIVE THIRD PARTY DATA IRS ALREADY HAS. THROUGH THE REPORTING OF INCOME VIA W-2'S AND INFORMATION DOCUMENTS SUCH AS 1099'S, THE IRS HAS THE INFORMATION CAPABILITY TO PREPARE RETURNS FOR A MAJORITY OF TAXPAYERS.

THE MOVE TO A RETURN FREE SYSTEM WILL REQUIRE THAT THE IRS PROCESS ALL AVAILABLE INFORMATION DOCUMENTS WITHIN THE FIRST THREE MONTHS FOLLOWING THE CLOSE OF A TAX YEAR. THIS ACCELERATION OF THE PROCESSING OF DOCUMENTS WILL HAVE VALUABLE "SPIN OFF" EFFECTS FOR OUR EXISTING INFORMATION DOCUMENT MATCHING PROGRAM. IN PARTICULAR, THE TIMELY PROCESSING OF DOCUMENTS WILL ENABLE THE SERVICE TO PROPOSE ADJUSTMENTS TO RETURNS ON A MORE CURRENT BASIS. THE MORE TIMELY AVAILABILITY OF INFORMATION WILL BE BENEFICIAL TO BOTH THE SERVICE AND TAXPAYERS.

BEGINNING WITH A PILOT PROGRAM, IRS WOULD FOCUS PREDOMINATELY ON THE FORM 1040EZ FILING POPULATION -- SINGLE INDIVIDUALS WITH NO DEPENDENTS AND LIMITED INTEREST INCOME WHO EARN UNDER $50,000. BASED ON 1983 FIGURES, IF WE BEGIN THE PROGRAM IN 1987 OR 1988, IT WOULD APPLY TO ABOUT 21 MILLION TAXPAYERS, OR ABOUT ONE-FIFTH OF THE TOTAL. BY THE EARLY 1990'S, THE PROGRAM COULD REACH MORE THAN 50% OF INDIVIDUAL TAXPAYERS. IN OTHER WORDS, BY THEN, OVER HALF OF THE TAXPAYERS WOULD NEVER HAVE TO WRESTLE WITH A TAX RETURN AGAIN. BY THE EARLY 1990'S, TAXPAYERS WOULD BE SPARED 71 MILLION HOURS IN ACTUAL RETURN PREPARATION AND UNTOLD AMOUNTS IN PREPARER FEES -- NOT TO MENTION CONSIDERABLE AGGRAVATION. WE THINK THE RETURN-FREE SYSTEM PROPOSAL MERITS SERIOUS CONSIDERATION AS PART OF OUR OVERALL REFORM PLAN.

CONCLUSION

MR. CHAIRMAN, AS I HAVE SAID, THE PRESENT SYSTEM CONTINUES TO WORK, BUT THE STRAINS ON THE SYSTEM ARE BEGINNING TO SHOW. FUNDAMENTAL TAX REFORM IS LONG OVERDUE.

FAIRNESS AND SIMPLICITY ARE KEY TO THE PROPER FUNCTIONING OF A VOLUNTARY COMPLIANCE SYSTEM. OUR CURRENT TAX SYSTEM NEEDS BOTH. THE PRESIDENT'S TAX PLAN TAKES SIGNIFICANT STRIDES TOWARD ADDRESSING THE MOST TROUBLING ASPECTS OF THE CURRENT LAW. IN ADDITION, THE PROPOSAL MAKES DRAMATIC REDUCTIONS OF MARGINAL RATES. THESE CHANGES WILL SIGNIFICANTLY ENHANCE THE OPERATION OF THE TAX ADMINISTRATION SYSTEM. TAXES WILL BE FAIRER, THEY WILL BE EASIER TO COLLECT, AND MILLIONS OF PEOPLE WILL BE SPARED THE DRUDGERY OF PREPARING AND FILING TAX RETURNS.

IN MY MORE THAN 35 YEARS OF EXPERIENCE WITH THE TAX SYSTEM IN BOTH PUBLIC AND PRIVATE LIFE, I HAVE NOT SEEN A BETTER OPPORTUNITY FOR FUNDAMENTAL TAX REFORM. I HOPE WE DO NOT MISS THIS HISTORIC OPPORTUNITY. THANK YOU.

The CHAIRMAN. Thank you, Mr. Commissioner.

Let me ask you three questions from Senator Dole first, then we will follow our normal 5-minute rule.

First, Senator Dole asks: What will it take a new computer capability, additional personnel, and other resources to implement the Return-Free Pilot Program described in the President's proposal, and how much will it cost?

Commissioner EGGER. We haven't totally completed our study on that, Mr. Chairman. The basic need is going to be for additional optical scanning equipment in order to read the information documents into the system in a very short timeframe. Right now we process those over a much longer period, and the Social Security Administration processes the W-2's. So, we will have to have the equipment, mainly.

Our preliminary study indicates that the number of personnel will not be as significant as the one-time cost of the equipment.

The CHAIRMAN. Will you need an increase rather than a decrease in personnel?

Commissioner EGGER. Yes, sir; an increase.

The CHAIRMAN. You have a suggested increase of about 1,200 personnel, as I recall, in the budget for next year.

Commissioner EGGER. Right. The fiscal 1986 budget as proposed would decrease our overall personnel by 1,254. That budget proposal was put in without any regard to the return-free system.

The CHAIRMAN. So, when you say an increase, do you mean you would need to keep the 1,274 and have an increase?

Commissioner EGGER. I don't think it will be 1986 that will be involved, Mr. Chairman; the bulk of the cost as we see it would be incurred in 1987 and 1988.

The CHAIRMAN. I want to come back to the numbers. Would you need to get back the 1254 people that would be eliminated? Would you have to fill those slots, plus others?

Commissioner EGGER. Yes, sir; that is correct.

The CHAIRMAN. All right.

What percentage of error does the IRS consider acceptable in processing tax returns, and what is your estimate of the error percentage this year?

Commissioner EGGER. I don't have the precise number, but our error rate differs depending on which aspect of processing we are looking at. What I would like to do is to supply for the record, if I might, Mr. Chairman, the various measures and the error rates which we have incurred.

The CHAIRMAN. Could you both supply it for the record and in a letter to Senator Dole, since it is his question?

Commissioner EGGER. Yes, of course.

The CHAIRMAN. Thank you.

[The information follows:]

Question What percentage of error does the IRS consider acceptable in processing tax returns and what is your estimate of the error percentage this year?

Response. The Service spends a great deal of its resources trying to ensure that refunds or bills sent to taxpayers are issued timely and accurately. When tax return data is transcribed into our computer system, the information is subjected to a number of consistency, validity, and math checks to identify both taxpayer and IRS processing errors. Tax returns that fail any of these checks are routed to an error correction function. Our records as of July 18, 1985, show that twenty-three point

six (23.6) percent of individual tax returns processed during 1985 were identified as potentially possessing errors and such returns went through the error correction process. Of the 23.6 percent, taxpayer errors account for 12.8 percent of all returns processed through this perfection function. The remaining 10.8 percent represents both IRS processing errors as well as returns with questionable items that we need to look at more closely. All of the returns that enter the error correction function must pass all of the validity checks before they are allowed to be processed further. This process corrects all errors we know of but there may be additional errors which remain and which are not identified by our quality control system.

As a final check on the accuracy of refunds or bills, we have a notice/refund review process that inspect a sample of the outgoing documents. Any items containing errors are cancelled so that corrections may be made. The sample criteria is directed to identifying documents having the highest possibility of error.

The CHAIRMAN. A third question from Senator Dole: What is the most current estimate of the underground economy? Are there additional compliance measures which we should consider? And do you have any preliminary data on the effectiveness of the compliance provisions enacted in 1982 as part of TEFRA?

Commissioner EGGER. We have just completed the 1982 Taxpayer Compliance Measurement Program, and we are in the process of analyzing that data right now. We don't yet have the preliminary figures. This would be for the 1982 tax year, and it would have not taken, of course, the effects of TEFRA into account.

My personal belief is that, when we see those figures finally, it will show that we are making progress certainly in the tax shelter area, and I think we are going to see for perhaps the first time in many, many years at least a leveling out if not an actual increase in the level of compliance. I am looking forward to our opportunity which will come later this year to share with the committee the results of that 1982 TCMP. But our figures currently still show that we have about an $82 billion tax gap in the legal sector; that is to say, we are using 1979 figures, which are the latest we had. We showed that by extrapolating those 1979 figures up to 1981, the tax gap was about $81.5 billion in the legal sector in 1981. And we have since extrapolated that, so we are projecting about $92 billion in the legal sector tax gap for 1986. That is the current figure. Now, when we get our 1982 numbers, we will of course revise those estimates.

The CHAIRMAN. That takes care of Senator Dole's questions. Now, let me ask you about your polling and taxpayer impressions of simplicity and fairness.

Commissioner EGGER. Yes.

The CHAIRMAN. Several years ago, Henry Block of H&R Block testified before this committee. He, obviously, polls extensively and is obviously interested in what people think about the tax system. He had done a poll asking a question about simplicity and found out that over 75 percent of the respondents wanted simpler taxes, simpler forms. He was surprised because he said most of them had simple forms now. You commented on how many people using the 1040EZ form seek the help of a tax preparer.

Commissioner EGGER. Yes.

The CHAIRMAN. Upon greater digging, he discovered that when people heard the word "simplicity" they were equating it with "fairness." He then recast the poll, and Taxpayers were asked: "Were they interested in simplicity for the sake of simplicity, or were they interested in fairness?" When asked that way, he said

that less than 5 percent cared about simplicity. Would that comport with your findings?

Commissioner EGGER. I suspect that wouldn't be far off from our own findings, Mr. Chairman. It is pretty clear to us that the vast majority of taxpayers, based on our survey of this last year, were concerned much more with what I would call the fairness aspects of the tax laws. In other words, their perception of the fairness of it permeated almost every response in the group.

So, I suspect strongly that, when it comes right down to it, the simplicity part of it is the concern, the fear of taxpayers that there is something in there that they don't know about.

The CHAIRMAN. Then what we want to be careful of in this tax bill is moving toward simplicity and giving the taxpayers the impression that that is the equivalent of fairness. It may be, it may not be.

Commissioner EGGER. That's right, and I certainly would urge that we do that very, very carefully so that we don't misguide ourselves or mislead ourselves in thinking that we are dealing with simplicity when we are really dealing with fairness.

The CHAIRMAN. I think we all find this same problem. If we move to a flat 10 percent tax, we catch all those rich people that don't pay any taxes, and it would cause the rest of our taxes to go down. However, you can't raise revenue or reduce the deficit at a flat rate of 10 percent. You could at about 14 or 15 percent if you taxed everything, including Social Security, or at least the employer-paid portion of it, all employee benefits, and some imputed income. As I look at that kind of system, it would cause the Tax Code to stand on its head and would lower almost everybody's taxes who makes over $30,000 and raise almost everybody's taxes who makes under $30,000.

Commissioner EGGER. I believe it would be very regressive, yes.

The CHAIRMAN. That's very simple.

Commissioner EGGER. Simple, but very regressive.

The CHAIRMAN. Most taxpayers, I would think, would not conceive of it as fair.

Now I want to go to ask about the drop from roughly 84 to 81 percent in compliance. Do you think that just because we make the system simpler, more people would comply? Or is the reason they don't comply because they think it is unfair regardless of simplicity?

Commissioner EGGER. I am not sure we can reduce the compliance to that sort of simple analysis. I believe those are all factors, but I have to say that I think the perception of fairness is much more important. In other words, it is either the taxpayers are resentful or they use it as a rationalization, and so they rationalize that, "Well, everybody else is cheating, so why shouldn't I?"

The CHAIRMAN. Here's where the very thinline between simplicity and fairness comes in. If we put in a good minimum individual and corporate tax so that we no longer have stories about how many people made over $200,000 and paid no tax, would that, plus some other elements of simplicity cause an appearness of fairness? Would the appearness of fairness cause more people to voluntarily pay their taxes because they became convinced the system had become fairer?

Commissioner EGGER. I doubt it would work, and the reason for that is that the problems that arise now come from the perception that other people are not paying their fair share. And to put any kind of a minimum tax in that would make the individuals pay truly a fair share, we would sort of be back to your 15-percent example, I think. I just doubt that that would do the trick.

The CHAIRMAN. Senator Roth. And the order that I have today is Senators Roth, Symms, Moynihan, Mitchell, and Long.

Senator ROTH. Mr. Egger, one of the President's stated goals in his reform package is to restore public confidence in our system, and I applaud him for that effort. But to be very, very candid, I think the IRS has recently done tremendous damage, enormous damage, to public confidence in the way it has been administering the Tax Code. And I particularly have in mind the Philadelphia office.

You say in your statement, "We believe significant progress has been made by the Service in the past couple of years in simplifying the problems taxpayers face in dealing with the tax administration system." I want you to know that I have never had so many complaints at any time in my long service in public office. We have been flooded with hundreds of examples of tax mistakes, and I understand that everyone makes mistakes, my office as well as the next. But what also concerns me is the arrogance. There has been no effort to correct these mistakes.

For example, the IRS erroneously sent out thousands of dunning notices to businesses in my region who had paid their taxes threatening property seizures for nonpayment of taxes. And you know better than I that that is a matter of real concern when a businessman or an individual receives that. Yet never, to my knowledge, has there been any effort to apologize to these people, who as I say were literally scared out of their wits.

Now, thousands of refunds are delayed. Frankly, our taxpayers can not only not get an apology, they can't even get an answer on the telephone.

Now, I understand it is the policy of the IRS that, if one hasn't gotten his refund in 16 weeks, a taxpayer should assume that his return was lost or eaten by some IRS gremlins and that he should refile and expect action in another 10 weeks, for a total of 26 weeks or 6 months from the time he originally filed. I have over 40 cases in just one of my district offices in a very small county in Delaware. Can you explain why this is happening and what we could be telling these taxpayers?

Commissioner EGGER. Senator Roth, we have had extensive hearings on this whole problem. A significant record has been built. Every single detail of the problems that we had in the massive conversion to a new computer system has been put on the record. I would be most happy to supply that, but it would take the rest of the morning for me to try to explain it in detail.

Senator ROTH. I am not interested in a detailed response, but have you in any way attempted to go to the taxpayers and explain, and apologize for the problem?

Commissioner EGGER. A letter of apology went to every one of those 26,000 taxpayers who received erroneous notices, Senator Roth. That was done back in February or March.

Senator ROTH. But what about the current situation where they can't even get an answer on the telephone?

Commissioner EGGER. The problem is that we forecast our facilities and the number of people on the telephones based on prior years' experience. This year, as soon as the stories began to hit the press about our problem in Philadelphia, the number of calls jumped up dramatically; in fact, they went up well over 50 percent above anything we anticipated. When that happened we had simply an impossible situation, in the sense that people call and of course get a busy signal because the system is just overburdened. And that is not something that we can turn around in a day or so, even if we had the resources to do it.

Senator ROTH. But, Mr. Egger, this matter has been going on for months now. We were told yesterday that in 1 month your Service would be able to implement a new tax law, and as far as I can tell you can't administer the old. It is not giving the American people or the people of Delaware in our region much confidence.

Don't you think that some current effort ought to be made to bring some people in to satisfy this? This is a matter of serious concern to a businessman or a taxpayer. And to say, "Just wait and refile," is that adequate?

Commissioner EGGER. Senator Roth, we have brought people from literally every part of the country, and together with the vendors of our system from literally every part of the world, to concentrate on the problems that we ran into with this conversion this year. And that is being done. In the Philadelphia office I have brought people from Fresno, California, from Cincinnati and various other places.

Senator ROTH. How many did you bring in, Mr. Egger?

Commissioner EGGER. I can't give you that figure right now.

Senator ROTH. Would you supply for the record how many are there?

Commissioner EGGER. Certainly.

[The information follows:]

Question How many personnel were brought into the Philadelphia Office to concentrate on the problems with the computer system conversion?

Response. One hundred Service personnel have been detailed to the Philadelphia Service Center since January 1, 1985, each one for various short periods of time. There have also been numerous visitations by National Office personnel during the first part of the year. Sperry Univac provided four people (including a field support team).

Senator ROTH. Let me just say that the performance is the worst in many years I have served, and it is something that is building a lack of confidence. And I think it demands your immediate attention.

Commissioner EGGER. Well, I can assure you, Senator Roth, it has had my undivided attention. Since back in January I have devoted many, many hours and days and weekends to travel. I have been to every one of the Service centers except three, and believe me that has been my top priority over the last 3 months.

Senator ROTH. Well, let me say the performance at this time is still not satisfactory.

The CHAIRMAN. Thank you, Mr. Symms.

Senator SYMMS. Mr. Egger, thank you very much. Along the lines of the questions the chairman asked about compliance, when I first went into the House, Wilbur Mills was chairman of the Ways and Means Committee, and he had one of his employees—I think his name was Larry Woodard—who charted the tax compliance and the percentage of the GNP of revenue the taxes took to the Treasury, and he kept a very extensive set of charts on that. He had it for years and years, and every time the taxes would go above 18 percent of the GNP he noted that compliance started dropping off, and he would go to Mr. Mills and tell him to do something to get some money back in the private sector. What is your impression of that?

Commissioner EGGER. I don't think there is much doubt but what the higher the taxes you impose on the taxpaying public, the more people will attempt to find ways to circumvent it.

Senator SYMMS. But do you think there is anything to that? I mean, it seems to me it was kind of an incredible chart, when you think about it, that when taxes would go above 18—like they are now, 19½ percent, I think, of GNP—compliance would go way down. And then if they would bring taxes back down, compliance would come back up.

Commissioner EGGER. Well, without trying to express any views on the precise numbers, I certainly agree in concept that does happen.

Senator SYMMS. Well, with respect to this date of enactment, Senator Dole asked that question yesterday to Secretary Baker, and there is a date of enactment on the deductions. It will be that the new deductions start on the first of the year, I believe, but the rates don't come in until halfway through the year. How much confusion will that cause? And what is it, just a one-shot revenue-increaser for Treasury?

Commissioner EGGER. I think it would make a difference, if I understand your question correctly, in the revenues for the first year.

Senator SYMMS. Would you anticipate, then, a big balloon of extra money coming in the first year?

Commissioner EGGER. No; it simply wouldn't reduce revenues. You see, what you are doing is putting in a new personal exemption, raising it to $2,000, and the ZBA goes up, and so on. And those things are effective the first of the year, which has a decreasing impact on the revenues. And so disallowing deductions and so on has the opposite effect. So, by playing off those two against the rate reduction taking place effective July 1, then it comes out with I think a slight decrease in revenues for 1986, and then a counterbalancing increase in 1987.

Senator SYMMS. Another question the chairman asked that I wanted to pursue a little further was about the rate. Now, with H&R Block and Henry Block, the chairman asked about the 14 percent, and he said if we accepted the rate of 14 percent and it included everything, we could have a simple tax, but above $30,000 people would pay less tax and below $30,000 they would pay more tax. Isn't it possible to raise the zero bracket and the personal exemption and make it progressive even if you did that?

The CHAIRMAN. Let me clarify that, Steve. I was just talking about the ultimate simplicity.

Senator SYMMS. Right.

The CHAIRMAN. If you start with no standard deduction, no dependency or any other deductions, and tax all income from whatever source derived, at about a 14-percent rate, you come out with about the same total as we have now. As soon as you start adding deductions or zero bracket amounts or anything else, it makes it slightly more complex. I was just taking the ultimate simplicity.

Senator SYMMS. Right. But I was wondering if the IRS is making an effort to try to, if it does anything, see about giving them one good, simple program.

My view of this program, as noble as it is in its effort, is that it isn't really going to simplfy our taxes much.

Commissioner EGGER. I think, again, the simplicity part of it does go to the individuals, that it isn't all that simplified in terms of business and corporations. And the real reason is that those are business transactions and financial transactions, so they are complex by themselves.

Senator SYMMS. If I could just ask one quick last question: In section 108—this relates to Senator Roth's question—in section 108 of the law where we had a problem in 1981, we went to mark it on commodity trades to stop what were the abuses primarily of people who made money outside or earned income outside of commodities and then moved into the commodities to use straddles to delay or avoid or at least offset their tax rates. The Congress then acted in 1984 to change that and spoke very clearly to it. Treasury has continually told me that they are intending to not try to prosecute, that their target never was the legitimate commodity traders but those people who had used it from another source. Yet, IRS is persistent in prosecuting in Chicago and New York, and so forth, and not dropping any of those cases. But it seems to me that is going right against the face of the law.

What is your explanation of that? And wouldn't it be better to take some of those people and send them to Philadelphia to work on the cases Mr. Roth is talking about than to continue to harass these taxpayers?

Commissioner EGGER. First off, I don't agree that we are harassing taxpayers, nor do I agree that the law is all that clear. As you know, this matter is in litigation.

Senator SYMMS. Didn't the court rule that the IRS was wrong, though, in another case?

Commissioner EGGER. In one case that the Tax Court did. But as you know, that is still open, in the sense that it is very likely that that case could be appealed.

Senator SYMMS. I know some of those people have offered to take their cases to the Tax Court and the IRS won't do it. And I'm told that they think they will——

Commissioner EGGER. I really should not comment on open cases, though, Senator Symms.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Thank you, Mr. Chairman.

May I welcome the Commissioner, who is very clear with his straightforward testimony? I can't imagine a more difficult job in Government, and it is one which burdens he carries with grace and candor.

I have just a very few questions, and I hope you won't mind if they verge on being comments.

You say, speaking of the complexity of the code, that the Deficit Reduction Act of 1984 was the 19th major legislative change in the tax law in 22 years. You could argue that there is a certain irony that that would as much be the case as not proposing the 20th as we are doing. I mean, it is hard to argue that a 275-page proposal is simplification; it's change, and it may be even better.

Let me say something heretical. We all-think it is admirable of the Service to think of this automatic tax return arrangement whereby we never have to fill it out. I am not so sure that is a good idea. I am not so sure but that citizens ought to make out their tax returns and, you know, have a kind of difficult evening jogging with the cat, and this sort of thing. And making taxes so simple that you don't even know you are paying them—well, it seems my friends and colleagues and Senator Symms might get alarmed at that.

Senator SYMMS. I think we ought to have them make them out just the night before the elections.

Senator MOYNIHAN. The nights before elections, and pay in silver dollars?

Senator SYMMS. Right. [Laughter.]

Commissioner EGGER. If I may comment, Senator Moynihan, I think we might have crossed that bridge when withholding was enacted.

Senator MOYNIHAN. But if that would happen, this would continue a direction. I won't pursue it further, but obviously we could have a discussion on it.

I do want to ask one thing, though, and that is: Without any emphasis on anything in the least discriminatory, the administration has got a tough problem of coming to us with large proposals which they say will be revenue-neutral and which then turn out to be hideously unbalanced.

The 1981 tax bill was supposed to cost no revenues, and it produced a permanent $200-million deficit. I mean, I think George Will has said that it changed the political conversation in Washington for a generation. And it will do, because we are both from our generation.

Now, yesterday in the Ways and Means Committee a series of respected economists, headed first by Martin Feldstein, who was the President's first chairman of the conference—he said of the tax proposal: "It would be a fiscal disaster if tax reform became a deficit-enlarging tax cut." He said Mr. Regan's plan was at best revenue neutral and has a substantial risk of losing revenue.

And Henry Aaron, who has served at Brookings, as you know, said:

> If there is one thing the United States economy does not need, in fact cannot stand, it is another tax cut that would make the deficit still worse, the dollar still stronger, and international competitiveness of the U.S. industries still weaker.

Mr. Chairman, I think we really are honor bound, it seems to me, to be certain that when we attest to the American people that this is revenue neutral, that it is.

Can you help us on that, sir? I mean, we have looked to the IRS to be calling them as you see them. We are going to get some revenue estimates. If we send them around to you, would you give us some answers on them?

Commissioner EGGER. Senator Moynihan, I am not an economist, and therefore I wouldn't——

Senator MOYNIHAN. But, in the disrespectful term of your profession, in a sense you are a "bean cutter," you count money.

Commissioner EGGER. A tax collector. Yes, sir.

Senator MOYNIHAN. You are a tax collector. If we show you some of the proposals we have, would you give us an estimate from the IRS, a professional estimate, just the judgment of your own people?

Commissioner EGGER. I believe that some of that information can be done through the Office of Tax Analysis in the Treasury, and I assure that we will be as helpful as we can possibly be.

Senator MOYNIHAN. I will take that as a very serious offer of help, because we do have to look to you all who do collect the money and add it up.

Commissioner EGGER. Right.

Senator MOYNIHAN. And if you could give us your best professional estimate of what is likely to happen.

Commissioner EGGER. Yes.

Senator MOYNIHAN. Thank you very much, and thank you for your testimony.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Commissioner, I join the other members of the committee in welcoming you.

In 1981, when we considered the tax bill of that year, the administration's representatives—the Secretary of the Treasury, the Budget Director, and others—came before this committee and testified with great confidence that if we just passed that bill, especially including the reduction of the maximum tax rate from 70 percent to 50 percent, that there would be a dramatic reduction in the use of shelters to avoid tax liability. The only reports I have seen indicate that the opposite has occurred and that shelter activity has, if anything, increased and not decreased.

I ask you, are you aware of any evidence to the contrary of that? What is your estimate of what has happened with respect to the use of tax shelters in the period between the enactment of the 1981 tax bill and the present?

Commissioner EGGER. As I responded to the chairman, we are in the process of analyzing our TCMP examinations for tax year 1982. I believe that will give us some insight into the effects of the 1981 legislation and how taxpayers are responding to it. We just don't have that information at this point.

However, it is my personal perception—and I will have to emphasize "perception"—based on lots of conversations with tax practitioners and groups in general all across the country, that we have made inroads into the tax shelter world; that is to say, practitioners assure me that they are not seeing anywhere near as many people attempting to shelter income, and certainly not to the degree that they did a few years ago. Now, some of that has to be a

direct result of what the Congress has done in 1981 and 1982, and again in 1984.

I wish there were some way that we could sort of leap over all that and get immediately reliable statistics. Unfortunately, it just takes years before we can assemble that data.

Senator MITCHELL. When do you expect that study to be completed?

Commissioner EGGER. The 1982 TCMP data will be analyzed probably in the latter months of the summer or early fall; probably around August or September we will begin to have a fair amount of the analysis completed.

Senator MITCHELL. Have you made an analysis of the President's plan related to the specific tax forms used by taxpayers? That is, what the forms would look like if the President's plan were enacted?

Commissioner EGGER. Yes; we have done that. It reduces the number of lines on the 1040 by about 10 lines as I recall.

The number of forms that have been eliminated has been considerable.

Senator MITCHELL. Let's take the three forms, 1040, 1040A, and 1040EZ. Would you tell me, please, what percentage of taxpayers now use those forms and how many lines that would be eliminated? You just said 1040 would eliminate 10 lines. It now has 68 lines, so it would go from 68 to 58?

Commissioner EGGER. Yes; the number of 1040EZ's that we received this past filing season, based on our preliminary estimates, is a little over 17 percent. The 1040A is about 19.6 percent, and the 1040 is the balance of nearly 63 percent. That is the ratio in which we are receiving those forms now.

Senator MITCHELL. Now, just a minute. We have had numerous statements made, and the President himself made the statement, that two-thirds of all taxpayers do not itemize on their returns.

Commissioner EGGER. That is correct.

Senator MITCHELL. Is that consistent with two-thirds filing the 1040?

Commissioner EGGER. Oh, yes; many people file the 1040 because they have some particular credit or above-the-line item that goes in, but they still don't itemize. Our statistics support that. There are about 36 or 37 percent of taxpayers who itemize.

Senator MITCHELL. Even though they could use another simpler form, the use the 1040?

The CHAIRMAN. That's where the confusion comes, George, in the technical use of the word "itemizing." There are still some credits and exclusions you can take on the 1040 that don't count in terms of the definition of "itemizing." That is where the difference in the terms comes.

Senator MITCHELL. May I ask that he just complete the answer as to the reduction of lines?

The CHAIRMAN. Yes.

Commissioner EGGER. I agree with the chairman's comment, but also we know that taxpayers and preparers frequently use a form that isn't needed. For example, we know that some preparers prepare 1040A's when the EZ would do, and so on.

Senator MITCHELL. Would you complete the answer with respect to the reduction of the number of lines on the 1040A's and EZ's? My time is up.

Commissioner EGGER. The A's and EZ's, we haven't done that kind of analysis. We have done it with the 1040 itself, which is the more complex return. We have not done it on the 1040A and the EZ. I don't think the EZ is going to change materially.

Senator MITCHELL. We cannot reduce it much below its eleven lines now.

Commissioner EGGER. Yes; it may be one line less because of the elimination of the above-the-line charitable contribution deduction.

Senator MITCHELL. I will resume on the next round.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Egger, a lot of the objection of the public to the unfairness of the tax system has to do with situations where the taxpayer took the deductions that he had every right to take. For example, some people up here on Capitol Hill love to issue a press release about certain corporations that paid no tax. And of that group, the largest single item involved was that many of those companies were doing business overseas. When they do business overseas, they are entitled to take a credit for what they pay in taxes to the foreign government.

That's different from one who is doing business within the United States. In this country you have a system where the Federal Government has the overall power but the local governments have their own sovereignty and power, so that we allow a deduction, usually, for what one has paid to the other levels of government. But I am told that this country is really no more favorable than other countries, and in fact less favorable than most countries, in its treatment of people doing business overseas. We allow them a tax credit for the taxes they have paid overseas, and many times that credit exceeds what they would owe in taxes here. And in that case, they owe no taxes in this country. That is correct, is it not?

Commissioner EGGER. Yes, sir.

Senator LONG. And you wouldn't recommend changing that?

Commissioner EGGER. The proposed change is simply in the manner in which the credit is applied.

Senator LONG. I know that you are suggesting that kind of change, but what I am talking about now is that if you do business in Pakistan or any country where the tax exceeds what you would pay in the United States, you get a credit.

Commissioner EGGER. Right.

Senator LONG. So in that case, you owe no tax here. Is that correct?

Commissioner EGGER. That is correct.

Senator LONG. Well, in so many cases I have seen where people are saying, "Here these people are who paid no taxes," particularly when they are talking about corporations, that really deserves an explanation, if someone wanted to tell the public the reason they owed no taxes here. If they did business in Pakistan, or some other country that has high taxes, they paid more money in taxes than they would owe here. And under our system, we would give them a credit for what they were paying the foreign government.

Incidentally, as among equal sovereigns, the rules are the same, as I understand it. If you buy something in one State where there is a sales tax and bring it back into another State, they will give you a credit in the State where you buy it if you have a similar tax to pay when you get back in the State where you live. So there is nothing unusual about one sovereign giving you a credit against the taxes you paid to another sovereign. And if we didn't do that, our people wouldn't be competitive.

I see that you have nodded your argument. Our country couldn't compete abroad if we didn't give them treatment along that line.

Commissioner EGGER. Right. I don't disagree with the concept of the foreign tax credit.

Senator LONG. The point that I want to make is that a lot of the public perception concerning fairness is based on misinformation or the matter just not having been explained.

Now, in some cases the taxpayers owe less because they gave a lot of money to charity. I am one of those who has raised the dickens about people getting by with paying no taxes when they were giving money to their own private foundation; but if they are giving it to public charities, that's a proper deduction where they shouldn't be critized, and no one should feel badly because someone owed about half as much taxes as he otherwise would if the reason is that he gave half what he made to education or to the church.

If you couple that with certain other appropriate and proper deductions, in many cases the tax can get down to a very low point without there being anything wrong or improper about it.

I feel that generally in these kinds of figures there are in many cases taxpayes who are entitled to have their situation explained rather than just having it charged that they are culprits or you might say "legal tax cheaters." I think that impression has been given altogether too often.

Commissioner EGGER. I appreciate that, Senator Long. My concern has been—for something over 4 years—with people who engage in activities which are, if not illegal, at least are activities which are beneficial only in the sense that they wind up reducing the tax bill, and that is in these abusive shelters. And that has been the area I think has created the perception of unfairness in the Tax Code.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Mr. Commissioner, yesterday or the day before the former Commissioner of the IRS Mr. Caplin testified before the Ways and Means Committee. He said:

> Over 22,000 tax shelter cases are now docketed in the U.S. Tax Court, out of a total inventory of 64,000. Also, some 350,000 tax shelter returns are currently either under examination or are pending before the IRS Appeals Office.

Would you have any guess as to what those figures might have been 10 to 15 years ago?

Commissioner EGGER. Yes; I believe in 1974 we had about 400 cases of tax shelters under examination.

Senator BRADLEY. Four hundred versus 350,000? So, if you want to know what is the biggest growth industry in the last 10 years——

Commissioner EGGER. I don't think there is any doubt about that, Senator Bradley.

Senator BRADLEY [continuing]. Those numbers are fairly revealing. They have gone from 400 to 350,000.

Now, you have said that your interest was to try to curtail those, and you have taken certain specific steps. What have you done?

Commissioner EGGER. My impression is that, number one, we have made significant inroads into the sheltering business. In other words, I think it has plateaued out and hopefully is even disappearing in some percentage.

Our examination program has been stepped up dramatically in terms of attempting to close out those cases. I believe when we get the final numbers for fiscal 1984 we will have closed out of examination something over 200,000 returns that are tax shelter returns, and that is out of about 1,200,000 individual examinations in total.

Senator BRADLEY. Do you mean you will have examined 200,000 of over a million returns that you classify use tax shelters?

Commissioner EGGER. That is correct.

Senator BRADLEY. So you would have examined about a fifth?

Commissioner EGGER. Yes.

Senator BRADLEY. And your normal examination of all returns is what? About 4 percent?

Commissioner EGGER. No, it is not that high. Across the board, covering corporations, partnerships, everything, it is about 1.35 or 1.4 percent of the total.

But, you see, we do this on a stratified basis, and so the return selection in the more complex returns and those which involve shelters would be upwards of 4 or 5 percent, in that narrow group.

Now, last year we probably will wind up assessing some $2 billion of revenue in tax shelter examinations alone, and those exams average out around $16,000 per return.

Senator BRADLEY. Will you give me those figures you have discussed?

Commissioner EGGER. Yes, we will do that.

[The figures follow:]

Examination's Tax Shelter Activities

Accomplishments fiscal year 1984:	
Total returns	1,331,091
Total dollars	14,250,049,774
Total dollar per return	10,706
Tax shelter returns	114,488
Tax shelter dollars	2,187,144,080
Tax shelter dollars per return	19,103

Coverage Percentage:

The total percentage of coverage during fiscal year 1984 for Income, Fiduciary, Estate and Gift Tax Examinations was 1.31 percent. The percentage of coverage for activity codes generally associated with Tax Shelters are listed below:

Activity Code:	Percent
006 Individual $50,000 and over	4.00
008 Sch "C" $25,000-$100,000	2.56
009 Sch "C" $100,000 and over	5.30
011 Sch "F" $25,000-$100,000	1.85
012 Sch "F" $100,000 and over	4.09
Partnership	1.57

Senator BRADLEY. Given what you have just said, how do you think the administration proposal is going to impact on tax shelters?

Now, I have read your testimony here, and I see that you talk about the investment tax credit and the changes in depreciation, and lower rates, and so forth; but the fact is that depreciation is still a fairly sizable subsidy—you still keep intangible drilling costs, you still keep, and in fact make more generous, the capital gains payoff. So the question is, how do you think this will affect tax shelters, given the fact that you have refrained from addressing some of the fundamental pillars of tax shelters?

Commissioner EGGER. Well, basically tax shelters all tend to be in the same pattern—that is to say, they are front-end loaded deductions, and they are cast in that form. Now, I am speaking of those that are at least not outright frauds. But they are cast in that form, and the principal element in there is the investment tax credit. The next principal element of course is the depreciation write-offs, combined with the interest deduction. And I think the at-risk rules extended to real estate syndications and real estate investments of that sort will go a long way in making it much more difficult for individual investors at least to simply buy into something that will buy them a four-to-one write-off or something of that sort.

Senator BRADLEY. Could you spell out one? What is your ballpark guess as to how much the administration proposal would reduce tax sheltering, keeping in mind that there are 350,000 cases now out there, and keeping in mind that there were 1,200,000 tax shelter returns? What would you say?

Commissioner EGGER. I don't think there are 1,200,000 tax shelter returns.

Senator BRADLEY. I thought you said that.

Commissioner EGGER. No; the 1,200,000 are the total number of individual examinations, and 200,000 of those were——

Senator BRADLEY. Can you give us a ballpark figures as to numbers?

Commissioner EGGER. We have not attempted to quantify that, and I would say it would be a function of not only a combination of these things, which I think are very important, but also the things that are already in the law, and a combination of how much exam activity we have put into it.

Right now we are examining what in my judgment is below the margin of the number of returns that we should be examining. Come 1987, our proposal is to start increasing that by a significant number of examining positions, of personnel.

Senator BRADLEY. Thank you.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Commissioner, I apologize for not being here at the beginning, but I was engaged on the floor during that period of time.

How many tax returns are there a year?

Commissioner EGGER. This year we received just about 100 million individual returns, Senator Bentsen.

Senator BENTSEN. You know, I have looked at that publicity, and I understand it emanated from the IRS, that there were—whatever it is—299 taxpayers or so who in 1982 made over $200,000 and paid no tax. Frankly, that disturbed me very much, because I feel everyone that makes an income ought to pay tax, and if they don't it helps destroy confidence in the system. And as you say, that is terribly important.

The CHAIRMAN. Could I ask a question, Lloyd?

They pay no tax, or no tax to the United States?

Senator BENTSEN. I hadn't finished.

So, as I dug into that, I found that of that number it appears that 146 of them show payments of foreign taxes. So there are only 139 out of approximately 100 million tax returns that show neither United States nor foreign taxes.

Then as I looked further, I found that casualty losses—for example, a home having burned down and things like that, and, out of 100 million people, that sort of thing can happen.

But the point is the way it is cast. We worked awfully hard on this committee to try to see that everybody pays taxes. But then you run into situations like that. And then this report is put out, and sure, people are going to say it is not fair, "That is not right," if they just get it glossed over that 299 made $200,000 and didn't pay any taxes.

Commissioner EGGER. That was not our report, Senator Bentsen.

Senator BENTSEN. The report did not emanate, then, from the IRS? I was told it had.

Commissioner EGGER. Well, they used the Statistics of Income data which we publish each and every year in huge volumes of statistics. But we didn't issue any such statement as that.

Senator BENTSEN. So they got the information from the IRS?

Commissioner EGGER. Yes, that's right.

Senator BENTSEN. Because I don't know anyone else who would have it.

Commissioner EGGER. The information is publicly available.

Senator BENTSEN. So they cast it to serve their purpose?

Commissioner EGGER. Yes, sir.

Senator BENTSEN. As it was presented.

Then, another one that concerns me, and I understand this has been touched on, is that I never in my lifetime have seen the number of complaints against the IRS—in responding to information requests by taxpayers, in lost tax returns, in inattention to problems and concerns, and to arbitrariness on the part of employees. What is the problem? Is it that we have not appropriated enough for staff? Is it that we are not paying sufficient salaries to compete with the private sector? Is it that we have not been able to make the transition to nascent computers? What is the problem?

Commissioner EGGER. I think you may be correct in all of those, Senator Bentsen. I think that this year, in particular, most of the problems of faulty credits, or failure to credit, of the delays in refunding, things of that sort, essentially all emanated from a very massive system conversion.

If I could take just a moment to go back, in the 1970's the Internal Revenue Service had designed a system which was fully state-of-the-art at that time. But between Members of Congress, some of them, and the then-administration, there was a concern that suddenly the IRS was going to be building dossiers on taxpayers and that we would be in George Orwell's "1984" and et cetera, et cetera. The consequence is that that system was eliminated; that is to say, the IRS was not permitted to go forward with it. As a consequence, in 1980 and 1981 we had to move quickly on a major system in order to keep up with the workload. We simply could not have begun to deal with the volumes of returns that were beginning to come at us without doing something to upgrade the capacity of the system. And we did it over a relatively short timeframe. That was a massive conversion by anybody's standard. There was nothing in the private sector like it. We rewrote some 1,500 programs in high level computer language, and some 3.5 million lines of coding had to go in there. We had new hardware and new software, and although we did as much testing as we could, you still do not know how something is going to perform under the heavy volumes we put into it this year until that does happen.

We had the National Science Foundation come in and take a look at it, we had outside consultants come in and take a look at it, and they all agreed we were doing what we had to do given the circumstances.

I am simply saying that this is not a case of people being arbitrary or disregarding the rights of taxpayers or their feelings, or anything. It was very demoralizing to the people in our service centers who were trying their best, working 80-hour weeks, 7-day weeks, in order to try to keep this system going. It was, by anybody's standard, a very traumatic year for all of us, and I want you to know that, sir.

Senator BENTSEN. Well, that can lead to short tempers and to arbitrary replies.

Commissioner EGGER. Yes, sir. And I understand it from the taxpayers 'point of view. Believe me, we are leaving no stone unturned to turn that around to see that it doesn't happen again, and to do everything we can to assure that the system that is in place performs as it should perform and we believe will.

I think that this is a one-time thing. I do not believe we will see anything like this in another year.

Senator BENTSEN. Are you gaining on it?

Commissioner EGGER. Oh, yes.

Senator BENTSEN. Will it be substantially improved by this time next year?

Commissioner EGGER. Oh, yes. By now we are ahead of last year. In the entire month of April, and for 8 straight weeks, we processed through the system 1 million more returns per week than we ever have in the history of the IRS.

The system is going to work. It is simply a matter that we had to go through a very, very difficult conversion period.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

It just so happens that a question I asked Senator Baker yesterday would involve the discussion we just had. My question was in regard to his optimistism. My concern is whether he wasn't being overly optimistic to say that if we passed a bill in December, that he would be able to get it implemented effective January 1 as he claimed.

Would you concur in Secretary Bakers judgment? I suppose maybe I am skeptical, considering these problems that were just discussed here.

Commissioner EGGER. I would like to comment on that. I know of the question asked of the Secretary yesterday and his response.[te

Let me say, to begin with we have withholding tables. And pretty clearly, if we passed the statute, the new law, on December 1, let's say, the employers simply couldn't be ready by January 1. So that would mean we would have to probably put the effective date of those withholding tables out "as of" maybe July 1, as we did before in the 1981 and 1982 acts.

The changes in the forms I believe could be done, because I don't see very much change in the 1985 forms. We would have to change some of the 1986 forms, of course. On the other parts of it, the guidance that is needed and so on, our offices work very, very closely with the members of the committee staffs up here, so we are pretty well prepared. And by the time the bill is actually passed, we are a long way down the line to getting out immediate guidance in the hands of the public, and we can do this.

So in my judgment, the Secretary was quite correct in saying that we could probably put it in place in the period of a month. But that would not include, in my judgment, the ability of employers to deal with the changeover in withholding. We would have to defer that most likely for a period of up to, say, July 1, which is the effective date of the rate change, anyway.

Senator GRASSLEY. I would like to turn to some aspects of the regulations drafting process, where the Treasury & the IRS fill in the details of our tax laws. My work on the IRS Oversight Subcommittee has given me some appreciation of the delays that can occur in that.

As of April 30 of this year there were about 460 open regulation projects; 79 of these were group A priority projects. A good number of these date back to changes in the Code that were made in 1976.

My first question is: How many of the current projects would be eliminated by the President's proposal?

Commissioner EGGER. I can't give you that answer right now, but I would certainly be happy to furnish it to you for the record.

[The information follows:]

EFFECT OF TAX REFORM PROPOSAL ON IRS' REGULATIONS BACKLOG

The IRS estimates that the President's tax reform proposal would allow some 17–20 existing regulations projects to be closed.

Senator GRASSLEY. Would you know, then, how many other projects you might expect to close by the end of the year of the 460?

Commissioner EGGER. We have a program, that is to say a work plan, for the regulations. And I think probably the best way to respond to your question is to supply you with a copy of the work plan that we have for the regulation publication project.

[The work plan follows:]

NUMBER OF REGULATIONS PROJECTS PROJECTED TO BE CLOSED IN 1985

The IRS published its "Semiannual Agenda of Regulations" in the Federal Register of April 29, 1985 (Vol. 50, No. 82, pages 17645–17772). That agenda showed 58 completed rulemaking actions and 538 current and projected rulemaking actions. Of the 538 current and projected projects, some 117 had completion dates in calendar 1985.

Commissioner EGGER. We and the Treasury have both worked assiduously to attempt to speed up this whole process of regulation development and publication. And I think we are making progress on it. But as I said before, with such a heavy legislative program as has occurred over the last 3 or 4 years, it is very hard to get ahead of it. But I think we will be making what I regard as good progress.

Senator GRASSLEY. Last on this point, then, in regard to the President's proposal that we are considering right now, how many new regulation projects would that create? And how long would you expect it would take for them to be completed assuming the plan is adopted as proposed?

Commissioner EGGER. It is just too early in the process for us to have made that estimate. We won't know that until we begin to see legislative language.

Senator GRASSLEY. Could you generalize? Do you see the overall issue as something you could respond to?

Commissioner EGGER. I will give you some comparison. We had something like 175 new projects as a result of the 1984 act itself.

Senator GRASSLEY. Well, that was a complicating act, right?

Commissioner EGGER. Yes, I think the 1984 act was.

Senator GRASSLEY. If we dropped the size of the code would we have lesser projects, as a result of the President's proposal? I mean, it is tax simplification, supposedly.

Commissioner EGGER. Yes.

I think it would be difficult to say that we will have fewer projects. I would say this, that a lot of them will be simpler because of the nature of the changes that are proposed in the President's proposal.

The CHAIRMAN. Let me followup on a question that Senators Bradley and Bentsen asked. Give me those figures first that you gave to Senator Bradley about the 39,000 and the 400. Were those tax shelter cases?

Commissioner EGGER. Yes, sir.

The CHAIRMAN. These are cases you are contesting?

Commissioner EGGER. These are cases under examination, Mr. Chairman. The 350,000 cases are cases in which we expect to propose deficiencies. The 22,000 cases——

The CHAIRMAN. Expect to propose what?

Commissioner EGGER. Deficiencies.

The CHAIRMAN. You make them pay more money?

Commissioner EGGER. Additional tax, right.

The CHAIRMAN. All right; 350 thousand?

Commissioner EGGER. That's right.

The CHAIRMAN. Now, what was the 39,000 figure and the 400 figure?

Commissioner EGGER. The 22,000, I think it was, cases docketed in the Tax Court are those that we have identified as tax shelter cases; clearly we are contesting those or they would not be there.

The CHAIRMAN. And 10 years ago that was 400?

Commissioner EGGER. No; 10 years ago we had under examination 400 tax shelter cases.

The CHAIRMAN. You didn't even have docketed 400?

Commissioner EGGER. That's correct.

The CHAIRMAN. Now you have docketed 22,000?

Commissioner EGGER. Yes, sir.

Senator BRADLEY. And under examination, 350.

The CHAIRMAN. As opposed to 400.

Commissioner EGGER. Right.

Senator BRADLEY. So the parallel number is 400 versus 350—350,000.

The CHAIRMAN. That is an incredible figure.

There is something I don't follow in enforcement. We have presumed all along that if we added more agents we would have more compliance and collect more money. I recall the figure being tossed around that every $1 in agents would give us $7 in compliance. Is that about right?

Commissioner EGGER. Yes, sir, on the margin that is correct. For our program as a whole, we return about $11 for each dollar in the examination programs.

The CHAIRMAN. You said in 1987 you are going to need more personnel; you would like to get about 1.3 or 1.4 percent audit and will simply have to have more personnel.

Commissioner EGGER. That is correct.

The CHAIRMAN. I don't understand the drop in personnel of 1254 in the budget, and then you are going to need more than the 1,254 for 1987.

Commissioner EGGER. Yes.

The CHAIRMAN. Is that figure yours? Did you request that of OMB, or did they say, "Mr. Commissioner, this is what you are going to ask for"?

Commissioner EGGER. I would like to give you a very straightforward answer to that—you said it right the second time. [Laughter.]

But the administration felt very committed to trying to have all agencies freeze at the fiscal 1985 level, and we were no exception. So that meant, in order to meet that budgetary level, we would have to reduce the number of positions by 1,254.

The CHAIRMAN. But if this committee and this Congress decided to not even pay any attention to the 1,254 cut but to give you additional personnel, you could put it to good use in better compliance?

Commissioner EGGER. Yes, sir; and let me say what I have already said on the record in our budget presentation, and that is that adding the 2,500 new positions in examination in each of 3 years would provide about $4.6 billion of additional revenue in that same 3-year period.

The CHAIRMAN. Say that again.

Commissioner EGGER. If we add 2,500 new positions in examination each year for a 3-year period——

The CHAIRMAN. Twenty-five hundred, 5,000, 7,500?

Commissioner EGGER. Correct.

The CHAIRMAN. It would produce how much, in your judgment?

Commissioner EGGER. $4.6 billion.

The CHAIRMAN. Total? Or each year additional?

Commissioner EGGER. That is in the aggregate. That is cumulative.

The CHAIRMAN. So for 7,500 more people, how much would that cost?

Commissioner EGGER. Give me just a second. [Pause.]

It is around $300 million.

The CHAIRMAN. So for $300 million over 3 years, we could reasonably expect to get $4.6 billion more revenue in compliance?

Commissioner EGGER. Absolutely.

The CHAIRMAN. Well, I appreciate your candor very much, and especially your candor that this figure didn't come from you.

Commissioner EGGER. I don't think there is any secret about it. In order to achieve that kind of a limitation across the board, everybody has to participate.

The CHAIRMAN. So the Commissioner has said, if we added 2,500 new personnel in each of the next three fiscal years, ending up with 7,500 more, that the total cost would be about $300 million and they would expect additional compliance of about $4.6 billion. The 1,254 cut next year, was not asked for; that the administration has cut personnel across-the-board in all agencies. He was very honest in saying it wasn't their suggestion. I asked him if in our judgment we were to give him more personnel could he put it to good use in compliance, and he said Yes.

Let's see. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Commissioner, earlier I asked you about the incidence of tax shelters, and you said you thought they were declining. I want to read you a couple of statements from a Joint Committee on Taxation report and then make clear what I gather is a significant difference in opinion between that committee and you.

The committee report says, and I will just read a couple of paragraphs—the headline is, "Why Is Tax Shelter Marketing Increasing?"

"The continuing growth of tax shelters may appear surprising, in view of the enactment of the Economic Recovery Tax Act of 1981, which reduced the top marginal rate from 70 to 50 percent, and the enactment of TEFRA in 1982, which was an effort to broaden the tax base and improve compliance.

"To understand why tax shelter activity has not abated it is useful to analyze the market for tax shelters." This is a report, incidentally, dated February 1984.

In another part of the report it says, "According to an industry newsletter," and in a footnote the newsletter is identified as "The Stangler Report" of that month, "taxpayers invested approximately $8.4 billion in public program tax advantaged investments in 1983, compared to approximately $5.5 billion in 1982. The largest increases from 1982 to 1983 were in real estate investments and investments in income-producing oil and gas properties. Many of these investments represent a real capital formation to the economy; however, the data are indicative of the increasing use of abusive tax shelters as well.

"The flourishing of tax shelters in recent years has affected the Administration's tax laws."

May I take it from your testimony that you simply disagreed with the Joint Committee on Taxation?

Commissioner EGGER. No; what I should have made clear is that I am talking about the tax shelters which we term "abusive shelters"; that is to say, those that we think are at best highly questionable under the laws.

There are clearly things being marketed, such as real estate investments, oil and gas drilling funds, things of that kind, which fall within the statute as it exists today. And as a consequence, if you take a full look at a report such as the Stanger Report, you will see that a lot of the sheltering has been now biased in that direction because people can buy into those things under existing law and essentially get their money back ~~in~~ 1, 2, or 3 years, and they don't have to care what the price of the property is because there is no personal liability on it.

So as a consequence, we have seen a very significant growth, particularly in commercial real estate which results in what I call "see-through buildings," where there are an awful lot of office buildings built but no tenants in them, simply because the investors had no interest in whether or not that was a good economic arrangement to go into.

But the abusive shelters, in my judgment, are coming down.

Senator MITCHELL. Then we are clear that there has been a continuing increase in the use of tax shelters to avoid the tax liability. There has been either a leveling off, which you said was your perception, or perhaps a decline of abusive tax shelters, which may be defined as "improper means of avoiding tax liabilities"?

Commissioner EGGER. Right.

Senator MITCHELL. Then I go back to my original question. In 1981 the administration witnesses all said, "Look, if you just reduce the maximum rate from 70 to 50 percent, the use of tax shelters"—it wasn't abusive tax shelters but the use of tax shelters—will decline. My point is, that has not occurred.

My question now is: What evidence is there that reducing the maximum tax rate from 50 to 35 percent will reducethe use of tax shelters? Is it not clear that people are always going to want to avoid liability on taxes, whatever the rate?

Commissioner EGGER. Yes, but it is one thing to avoid liability on the taxes; it is quite another when the only thing at risk is a 35-

percent tax bite, whether it makes sense to go into something for which you would then have full personal liability that doesn't have any good, sound economic basis. I think that is the rationale.

Senator MITCHELL. But that was the same rationale in going from 70 to 50 percent.

Commissioner EGGER. Yes, and I don't think we know the answer to that yet, and we won't know it until we see the final statistics.

Senator MITCHELL. But if the best and most reliable predicter of future human behavior is past human behavior, then the experience of the last 4 years when we went from 70 to 50 and the use of tax shelters continued to increase doesn't bode well for the next 4 years, even assuming we go from 50 to 35 percent. Is that a fair statement?

Commissioner EGGER. I think the question is going to be whether we have seen an improvement in the compliance trend at that point.

Obviously, as long as the law permits people to engage in what I call "tax-sheltering activities," they are going to do it, and some will do it at whatever rate. But I think there is a tendency, if you reduce the rate, for people to say, "Well, why risk 100 cents on the dollar for only a 35-cent write-off."

Senator MITCHELL. That may be what logic and common sense dictates, but experience is directly to the contrary, Mr. Commissioner.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Egger, I have been around here long enough to gain the impression that so often we are delayed in doing something until it is overdue, and then when we do get around to dealing with it we tend to overdo it.

I was on this committee when we handled the Tax Reform Act of 1969—I think that is what we officially called it, "tax reform," and we have been using that word ever since—primarily to go after people who weren't paying any taxes. That is what we did. We went after charitable contributions. We went after private foundations. We went after investment interest deductions. One of the things we did at that time was to repeal the investment tax credit.

On the House side they took out 7,500 tax returns and went after those 7,500 taxpayers who made a lot of money and paid little taxes. By the time we got through with all of that, we felt we had done a great job.

That is what put 50,000 tax lawyers to work overtime, finding deductions that nobody had thought about before. People say that's when the tax shelter business got started, when we wrote that so-called Tax Reform Act, because all that income that we were going after was subject to a 70-percent rate. All those high taxpayers went down to see their tax lawyers to find ideas to reduce their tax liabilities.

Repealing the investment tax credit seemed to be what more than any single thing triggered the recession that followed, because by about August of the following year President Nixon was frantically calling on us to reinstate the investment tax credit. He had agreed to go along with the repeal of it, but he was frantically saying, "Please put that investment tax credit back in the law." And then he proceeded to ease up or to give more favorable guide-

lines for depreciation. When we did that, it brought us out of that recession.

But if I go along with you people now, and I am inclined to do so at the moment, this will be the third time I have voted to repeal the investment tax credit. [Laughter.]

I have voted for it three times, and this will be the third time I have voted to repeal it. The other two times, the same President that recommended that we repeal it recommended that we put it back on again. I hope we are not going through the same exercise all over again. If the President later recommends that we put it back, and that we give back some of this depreciation that is being taken away, I will certainly consider it and appreciate his fairness in admitting that he made a mistake in recommending it to begin with.

But I hope that when we go along with you on this, we are not going to have to have a third time deciding that we made a mistake repealing the investment tax credit.

Commissioner EGGER. I certainly hope you are right, Senator Long. I have lived through all of that myself, having started in the tax business in the 1940's. So I have observed all of that, and I truly believe that we can put a tax system in place which will achieve what we call "horizontal equity," in the sense that the system will require that people with the same level of income pay essentially the same level of tax. I think that is so essential if we are going to have a tax system which is dependent, as ours is, on voluntary compliance.

Senator LONG. I will choose another subject. I have said, and the record will prove me correct on this, that your proposal to disallow charitable contributions at first didn't have a snowball's chance. And I see it is not in what the President is recommending, that the administration was satisfied that that was not going to pass.

I have said all along, though, that it seemed to me you could, if you wanted to, take that deduction off the tax return. The way you could do it would be to simply say that a person is entitled to a deduction, but in the fine print of the law he was assigning the right to a refund for that deduction to the charity to whom he was making the contribution. And in that case, if I wanted to make a $100 contribution to the church, I would give them $65, and they would go settle up with the IRS to get the other $35.

Now, in that case, instead of you having an audit and having to check up on 100 million people who make contributions, you would only have to settle with the charities who were collecting the money. Let them come and show what they had been given and settle up. A person would know what his tax bracket was, and they could settle up. He would have no particular reason to cheat you, because he would not be getting the money; it would be the charity that gets the money.

You could audit some, and they would all work out an average, for the Red Cross or for whatever church you wanted to check with, and say, "Well, on the average it works out that they are entitled to a certain amount," the weighted average of the contributions.

Do you see what I am talking about?

Commissioner EGGER. I see it, but I fear for the complexity that it would add to our process, since obviously we would have to process and essentially audit a very, very high percentage of those returns.

Senator LONG. All you would have to do would be to settle up with the charities, the universities, et cetera. Let them come and say, "You owe us this much." They would say, "Here is the contribution we got in, and here is the amount that we are entitled to," based on the brackets that these taxpayers were in.

The difference is that, instead of you having to do business with 100 million taxpayers, you would only have to do business with 10,000 organizations, or something like that. In short order, I think it could work out what the average amount of a refund would be. That way you could have your tax system take care of about 50 percent more taxpayers than you could have under your proposed automatic system, it looks like to me, because when you took the charitable contribution out of it, that would drastically reduce the number of people who would use the automatic return, wouldn't it?

Commissioner EGGER. Oh, yes, it would make a big difference.

Senator LONG. Thank you.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Egger, how is the returnless return supposed to work? You are going to be filling out tax returns for a lot of the American people.

Commissioner EGGER. Let me give you a quick thumbnail sketch of how it will work.

First off, we get from employers and other payers now information on compensation—wages, salaries, et cetera—and we receive that information currently. We also receive information from financial institutions, payers of interest, dividends, that kind of thing.

Our belief is, since we process all of this and have the capability to aggregate it by taxpayer account, that instead of the taxpayer filing a return and telling us something, and then we later on run all this information and verify that, that we could simply process the information and develop, if you will, a statement of income for a taxpayer. We would then compute the tax. We would have to receive from the taxpayer in the form of a post card or something the filing status, number of dependents, that sort of thing, and then we would run that, and our system would produce a tax computation for that taxpayer.

We would then send the taxpayer the computation together with the details of what went into that, and invite their correction if there is some error in it; otherwise we would simply then go forward with processing either the refund or a bill, depending on which way it came out with the taxpayer.

Since we have all of the information now, and we process all of that information now, it isn't such a large step to simply doing it for the taxpayer instead of them having to do it.

Senator BRADLEY. A lot of States have income tax returns too.

Commissioner EGGER. Right.

Senator BRADLEY. Would you expect them to go to this type of system? Because if they don't, the taxpayer still has got to fill out his State income tax return.

Commissioner EGGER. We have talked about the State tax situation at some length. My personal belief is that probably one of two things would happen. First of all, as you know, there is already legal authority on the books for any State that wants to conform their tax laws to the Federal to come in and simply invite us to administer the law for them, and we have to do it under the law. So far no State has done that.

But the other option would be for the State simply to defer the receipt of their return maybe a month or so, and then when we supplied the information to the individual he could just send a copy to the State, or something of that sort.

I think those things can be worked out, but I think it is up to the individual States whether they want to do it that way or not.

Senator BRADLEY. Well, let's say that I am a wage earner and according to the information you get, I earn a salary, a few interests on savings deposits, et cetera. And I go along like this for 4 or 5 years, and I'm dependent on the IRS, and the system has evolved now to the point where you automatically say that the people who have the IRS compute their returns are in one category, and then all the other people who are doing their returns are in a separate category.

Then let's say that I decide I am going to sell a piece of property that I inherited. So I sell it. What is the check? The IRS is preparing my returns. You don't get a copy of the capital gains that I just got.

Commissioner EGGER. Yes, we should.

Senator BRADLEY. What is the check?

Commissioner EGGER. We should get an information return on the disposition of that property. We don't have that as a rule right now, but we have authority to do it, and we have a project underway looking at the reporting of that kind of information.

Senator BRADLEY. Do you mean if I inherited three acres from my grandmother, and I sold it to my next door neighbor, and he wrote me a check? How do you get that transaction?

Commissioner EGGER. There would be a reporting—this is my concept of it, since we haven't fully developed the project—there would be a reporting by the title company or whoever handles the recording of that transaction.

Senator BRADLEY. So that, in this returnless system, essentially the taxpayer takes your work as first draft, and then changes it? If he wanted you to do it and he had a capital gain, how does he get the information to you? You would do it all?

Commissioner EGGER. Yes.

Senator BRADLEY. The appeal of this is, "I don't have to worry about this; the IRS is going to do it all for me"?

Commissioner EGGER. Well, each year he has to certify that he is eligible, and that means that he has to at least be responsible to know what comes in to him in the way of income. And if he had a capital gain that year, he is not eligible.

Senator BRADLEY. He is not eligible?

Commissioner EGGER. He would not be eligible under our present concept, no, because we have no way of being able to develop the gain or loss figures on a capital gain.

Senator BRADLEY. So he has to opt out of the system?

Commissioner EGGER. Right. Yes, sir. Or, saying it more accurately, he has to opt into the system each time.

Senator MITCHELL. May I ask just one question to followup?

The CHAIRMAN. Yes.

Senator MITCHELL. Does he have to make a certification? Does he have to file something?

Commissioner EGGER. We need individual taxpayer information such as filing status, whether he is going to file jointly, or whether he has two dependents or three or four. We would incorporate all that probably in some sort of a turnaround document, such as a postcard, and that would contain a certification which he would need to sign.

Senator MITCHELL. Instead of filing a tax return, he would file another form?

Commissioner EGGER. He would file a postcard, without having to get into the financial details.

Senator BRADLEY. And then he would file a separate form if had capital gains?

Commissioner EGGER. If he is not eligible for the system, then he has to file a return. Yes.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Back to the discussion on regulations, particularly as it relates to regulations that would have to be written in regard to the President's proposal, assuming the tax bill would pass this year, how long of a moratorium on further tax revisions would you like Congress to declare so that you could get that job caught up and done right?

Commissioner EGGER. It is my hope, Senator Grassley, that the Congress will perceive this effort as I do—a major shift in the way we approach income taxation in this country. We would go to a system of taxation which would no longer have room for the changing of this allowance or that deduction or this credit or something else. And all by itself, that ought to go a long way to eliminating this annual tax reform act, or whatever it is that the Congress has needed to do under the present concept, where each year we have to monitor the system and take a look to see whether we should do something more, or let somebody have this, or take this away from them, and so on.

Senator GRASSLEY. Do you really see the President's proposal as falling into that purest form you have just described?

Commissioner EGGER. I think that is the direction it should go, yes.

Senator GRASSLEY. But I mean this proposal that we have before us now. Do you see it at that?

Commissioner EGGER. I think it goes a long way in that direction, yes, indeed.

Senator GRASSLEY. Well, I am not sure I do, but then, maybe I will be convinced of it.

I would like to turn to another part of the proposal. The President's proposal would eliminate the deduction for business expenses unless they exceed 1 percent of the adjusted gross income.

Of course, the rationale for that is the simplification of recordkeeping. The same provision, though, would not require that those claiming the deduction include reimbursed expenses in the gross income. I am concerned that this provision will make things simpler for some taxpayers and for the IRS but without addressing the perceived inequity of reimbursed expenses not included in the taxpayer's income. Are we providing some sort of a fringe benefit in this provision that the President is taking away from another group?

Commissioner EGGER. No; I don't think so. What that 1 percent floor, is is an attempt to just aggregate a number of expenses of the type which might be above or even some of them below the line, and to simply only permit those which are in excess of 1 percent.

Senator GRASSLEY. Oh! I am assuming, in cases where you have reimbursed expenditures, that in every instance they are not a wash.

Commissioner EGGER. Well, we don't require it now. We have under the present law——

Senator GRASSLEY. Well, in some instances, some of that reimbursement could be real income that is not going to be reported?

Commissioner EGGER. If the individual is reimbursed for expenses which are either not deductible or for expenses in excess of the amount actually spent.

Senator GRASSLEY. Well, from that standpoint then, that would be income that in a very real sense would be a fringe benefit that wouldn't be taxed. Right? If that person's business deduction was under that 1 percent threshhold?

Commissioner EGGER. Yes; the way we control that now, of course, is to require adequate accounting. And if the adequate accounting is not there and not required, then the individual has to report the reimbursement, but that is almost never.

Senator GRASSLEY. In this particular instance we are not requiring the accounting. So, there is not going to be any——

Commissioner EGGER. Well, we require the accounting. The statute and regulations are clear on that, that an accounting to the employer or whoever does the reimbursing is made. And I think most employers do require it, because after all it is their money.

Senator GRASSLEY. You require the employer to account?

Commissioner EGGER. To require the employee to account, yes.

Senator GRASSLEY. Well, I understand that where you have the 1 percent, you are under the 1-percent threshhold, you don't have to keep recordkeeping of your expenses. But you are saying, though, the proposal does require, in the case of reimbursement, recordkeeping for the reimbursement.

Commissioner EGGER. The employer is going to require that. We are not. The law requires that the employee account to his employer.

Senator GRASSLEY. OK. But there is no record that the employee has to keep that that is income to him?

Commissioner EGGER. That is correct, if he accounts to the employer.

Senator GRASSLEY. So, from that standpoint there is no record-keeping.

Commissioner EGGER. Right.

Senator GRASSLEY. So, from that standpoint, you have nothing to check on.

Commissioner EGGER. Right.

Senator GRASSLEY. I mean the bill doesn't require it.

Commissioner EGGER. Right. And it doesn't change existing law.

Senator GRASSLEY. So, you see that as being OK. That's the bottom line?

Commissioner EGGER. I haven't seen it as any kind of a problem.

Senator GRASSLEY. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Commissioner, I am sorry I missed that part where you were talking about new agents, what you would get. I think it was with 2,500 agents each year, over 3 years you could pick up $1 billion.

My question here isn't strictly devoted to tax reform, but it is about our personnel problems and our concerns therewith. Do you think you can get good, competent agents, 2,500 a year? I have had some IRS people come to see me, and they are quite disturbed over what Congress is doing in the budget plan, the effects on the retirement and so forth. Would you briefly touch on that?

Commissioner EGGER. Well, I can only say this: Right now we have a very difficult competitive position, because we hire probably more accounting graduates than almost any other employer in the country, and the differential in the entry level salaries has continued to grow throughout my 4 years in this office, and it is now fairly significant.

So, that being the case, we will encounter some difficulties there. But what we hope to do is to get in early and interview the June graduates, if you will, and be in a position to put them on the payroll right then and there instead of waiting until October or so before we can bring them on when we will have less of a chance to get a fair representation of the top students.

Senator CHAFEE. Well, I just want to say as one Senator I am concerned with this. I don't know what the route is for you to convey our worries about pay and so forth. I guess that is through Senator Roth's committee. But I think we ought to be alert to being competitive here in our salaries so we can get the good people.

Commissioner EGGER. Well, I certainly support that idea.

Senator CHAFEE. Just in summary, do you think you are in trouble now with what we are doing, particularly as concerns the pension programs?

Commissioner EGGER. There is a great deal of nervousness that I perceive as I go around the country and meet with our staff people in any one of our 700 locations around the country. There is a great deal of nervousness about what is going to happen.

I think the most important thing is that the Congress move along quickly and make the decisions so people are aware and know what is going to happen.

Senator CHAFEE. Now, in of all of this discussion we keep coming back to fairness. I would just like to briefly talk about the tax-free fringe benefits.

I have a terrible time understanding the fairness of taxing the first $300. You have two people side by side, one with extraordinary fringe benefits and the other with very limited, but $300 worth. And yet they each are subject to the same tax, or at least have the same income counted. How in the dickens is that fair?

Commissioner EGGER. Well——

Senator CHAFEE. I heard you over the squawk box talk about wanting to have people with the same income pay the same tax. Well, indeed, when something is paid for you it is income in a way, whether it is life insurance or health insurance or education, whatever it is. And yet the tax isn't the same here, at least the income part of it.

Commissioner EGGER. Well, as Secretary Baker said yesterday, probably we would prefer to use a cap the other way around, but the perception is that the Congress, taken as a whole, would prefer to go the other way. So, there it is.

Senator CHAFEE. Well, I don't know what the Congress is, but we will see. Here is one person, and if it can be explained to me and I can somehow understand it, I, certainly, am not objecting.

Commissioner EGGER. One of the things is that in those instances, first of all, we are not talking about employees who don't have some kind of medical coverage. My own experience tells me that there are very, very few instances where the medical coverage is as low as $300 a year per family. And so, therefore, where people are receiving that as a fringe benefit, I strongly suspect that the $300 is a relatively small percentage of it. It would be the unusual case where that constituted a very large proportion.

Senator CHAFEE. I guess my time is up, but could I ask one more 30 second question?

The CHAIRMAN. Yes.

Senator CHAFEE. On page 5 of your statement you list some of the corrections that the President has suggested. The first and foremost is repeal of the investment tax credit. Are the rest of them in order of priority, as you see it?

Commissioner EGGER. I don't think we intended to put them in that kind of order of priority, but I have to say I think, with respect to most of the shelter packages that I have seen, the investment tax credit is probably the most valuable to the promoters and the investors, with one exception, and that is some of these things such as the rehabilitation credit and so on, which are very significant.

The CHAIRMAN. Do you mean as a shelter?

Commissioner EGGER. Yes, sir.

Senator CHAFEE. Well, what about something that can't be syndicated, like a manufacturing company's investment tax credit? Now, that wouldn't be an abuse, would it? Would that fall under this ITC image in here?

Commissioner EGGER. I think the investment tax credit vis-a-vis the users for whom it was originally conceived, the combination of that and the accelerated depreciation and the full deduction for nominal interest, and so on, all of those things combine to produce

a negative tax benefit in many ways. That is to say, they get more benefit than 100 cents on the dollar, and that was the concern here.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus.

Commissioner EGGER. Mr. Chairman, could I correct something here?

The CHAIRMAN. Yes.

Commissioner EGGER. I am just now reminded that I gave you a wrong estimate on the cost of the 2,500–7,500 revenue agents. The cost is not $300 million but $600 million. The $4.6 billion, however, is a correct number.

The CHAIRMAN. You still come out with a net of $4 billion?

Commissioner EGGER. Yes, sir.

The CHAIRMAN. Thank you.

Senator Baucus.

Senator BAUCUS. Thank you very much, Mr. Chairman.

Mr. Egger, I understand that OMB estimates that IRS regulations this year will account for about 35 percent of the paperwork burden placed upon Americans. Is that about right?

Commissioner EGGER. I think that has been the case for a long, long time, Senator Baucus. The paperwork in the tax system has always been a very, very significant percentage of the total.

Senator BAUCUS. Under, the administration's proposal, do you expect that 35 percent figure to change?

Commissioner EGGER. We certainly do. The return-free system itself, when fully implemented, we anticipate will cut a significant amount of the paperwork burden from the taxpayers.

Senator BAUCUS. Have you got any estimates?

Commissioner EGGER. Well, our estimate is that it will reduce the paperwork burden the way it is counted by OMB some 71 million hours. Now, I don't know what percentage of the total that is, offhand, but we could supply that for you if you like.

Senator BAUCUS. It is designed to reduce the paperwork burden on Americans by 71 million hours?

Commissioner EGGER. Hours.

Senator BAUCUS. Hours.

Commissioner EGGER. Yes; and I am reminded that that is just the preparation of the return itself. That does not include the recordkeeping and all of the other things that take up taxpayers 'time and create paperwork for them.

Senator BAUCUS. I would appreciate it if you would supply information on percentage reduction for the record.

[The information follows:]

BURDEN REDUCTION OF RETURN-FREE SYSTEM VS. TOTAL BURDEN

We estimate that the return-free system, when fully implemented, will reduce the paperwork burden on individuals by 71 million hours. This represents 25% of the burden imposed on individual taxpayers and 10% of the total burden imposed by the tax system on all taxpayers. The 25% reduction figure is more relevant because the return-free system is aimed at individual taxpayers.

Senator BAUCUS. What is your gut guess on that, as a practical matter?

Commissioner EGGER. I just can't give you a percentage, because I don't know what all is encompassed in that.

Senator BAUCUS. But you know the Tax Code pretty well.

Commissioner EGGER. I know what's involved here, and I can tell you that we can eliminate or substantially reduce some 20-odd forms that are now required to be filed by taxpayers, and things of that kind, but I can't translate that in terms of a percentage of the total paperwork burden in the country.

Senator BAUCUS. What about its application to small business? I'm sure you know, there are consistent figures about the concern of small business in America about paperwork.

Commissioner EGGER. Yes, sir, I am aware of that.

Senator BAUCUS. It is a tough problem for them, because the small business obviously doesn't have the resources to hire the financial services that the larger business can hire. Will this proposal increase or decrease the paperwork burden as it applies to the small business?

Commissioner EGGER. It should decrease it to some extent.

Senator BAUCUS. Why?

Commissioner EGGER. For example, currently the small business that wants to take advantage of LIFO inventory accounting can now achieve essentially that same result through indexing the FIFO. The FIFO is a lot simpler inventory accounting process, and the indexing of that would be a once-a-year exercise from a table that we would produce. And I think, in that specific respect, it would simplify considerably for small businesses the ability to take advantage of the inventory accounting, which would in effect squeeze the impact of inflation out of it.

Senator BAUCUS. Could you also, for the record, supply the degree to which this proposal, in your best estimate, will decrease the paperwork burden for small business?

Commissioner EGGER. I would be glad to go through it.

Senator BAUCUS. If you could. And I would like you, to the best you can, quantify it, as well.

Commissioner EGGER. I'm sorry?

Senator BAUCUS. Quantify the reduction.

Commissioner EGGER. It is very difficult to do until we see something in more concrete terms—that is, the statutory language, and so on.

Senator BAUCUS. I mean taking the proposal as proposed by the administration.

[The information follows:]

EFFECT OF TAX REFORM ON SMALL BUSINESS

We believe the paperwork burden for all businesses, in general, would be reduced by the President's tax reform proposals. Therefore, the paperwork burden for small business would be reduced. However, we are unable at the present time to quantify the exact reduction for small business. One of the reasons for this is the problem in defining what a small business is. In addition, the general language of the proposals would have to be redrawn into specific statutory language before we could draft the reporting forms that would enable us to quantify the burden. A lengthy and costly study would be required to estimate the paperwork burden for small business. At the present time we do not have the resources to engage in such a study.

Senator BAUCUS. What would be your reaction to the Congress amending the Regulatory Flexibility Act, which you know requires

Federal agencies to analyze the impact regulations have on small business. That act has been interpreted to apply, at least for the IRS, only to formal regulations and not to interpretive regulations.

Commissioner EGGER. Yes.

Senator BAUCUS. What would be your reaction if the law were amended to apply not only to formal regulations but also interpretive regulations.

Commissioner EGGER. Well, I think it would slow down dramatically the turnaround time and increase significantly the amount of resources we would have to put into the development of regulations. And in my judgment, it wouldn't be worth it annually.

Senator BAUCUS. Since most IRS regulations are interpretive and therefore have a great economic impact on small business, why wouldn't it be fairer to apply the act to these regulations?

Commissioner EGGER. Well, because the idea behind the Regulation Flexibility Act was to see to it that agencies did not put out unnecessary regulations, or regulations which put an unrealistic or an unreal or unnecessary burden on business. And here all we are doing is interpreting what the Congress has written into the law. So it seems to me that the question of the impact on small business has to be considered at the time the law is written.

Senator BAUCUS. I understand that, and my time is up.

The CHAIRMAN. Go ahead.

Senator BAUCUS. Although Congress passes laws and the agencies are charged with interpreting those laws, and there obviously are a lot of possible interpretations that have a significant effect.

Commissioner EGGER. It is our standard practice to analyze each and every regulation from the standpoint of impact on small business, in any event, even without going through the formal reg-flex process.

Senator BAUCUS. As a matter of fact, anyway, it seems to me an agency shouldn't be too upset if it were required to go through this process.

Commissioner EGGER. There is a great deal of paperwork involved in trying to comply with each and every one of those.

Senator BAUCUS. I understand that, but isn't it fairer to the American people not to have that burden on individual Americans, particularly on small businesses who are trying to compete?

Commissioner EGGER. One of the things that people tend to lose sight of is that we put out our regulations when we can possibly do so in proposed form, and we invite comments. And that is an opportunity for small business. And they do this—they come in and explain that the way we are interpreting it or the way we are applying it is posing too significant a burden on small business. And we want them to continue to do that. Frankly, I think that is the most efficient way to get it done.

The CHAIRMAN. A few miscellaneous questions, Mr. Commissioner.

We have been operating under the theory that the lower the maximum rate, the less attractive shelters would be. I thought I heard you respond to Senator Mitchell or perhaps to Senator Bradley that that theory may not be true. Did I misunderstand your answer?

Commissioner EGGER. No, I don't think it is not true. I simply said that at this time we do not have concrete evidence to prove that that is the way it happens. That is my perception. Although I have seen some shelters, such as the real estate syndications, go up fairly dramatically in the last few years, I believe overall that the tax shelter business is tending to go the other direction.

You look at what the Congress has done in 1981 and 1982 and again in 1984 in the compliance area, and I think those will be seen to have, in due course, a very significant impact on the tax sheltering business.

The CHAIRMAN. In this business most of us act on subjective rather than objective information, and in the long run I find it is probably as accurate as objective information. I have been going around just asking people, "At what rate would the tax level have to be before deductions would be more or less irrelevant to you? And if you want to also give me your judgment as to your friends, fine." With a few exceptions what I get is, "Oh, 25 or 30 percent, at that rate." And they said especially—they mentioned real estate—that they would be reluctant to go into syndicated ventures where first they have got some upfront management costs. Clearly, it is a greater risk than a certificate of deposit, and that at 25 or 30 percent they would probably not do it, or think their friends wouldn't do it. I sense they may be right. I heard one person say, "I don't care what it is; if it is 5 percent I'll still do it." But that was not the norm.

Do you have a subjective feeling that that may be right?

Commissioner EGGER. I don't have any way of identifying the percentage, because I haven't attempted to do any kind of a personal survey on it. My own belief, though, is that the lower the tax rate, the more tendency there is for people to say, "Gee, the risk isn't worth it; I'll stick to this or that."

The CHAIRMAN. Well, the headache isn't worth it, because it is not all that simple.

Commissioner EGGER. Yes.

The CHAIRMAN. Now a second unrelated question: On page 6 of your testimony you talk about the legal sector gap. "In 1983 the IRS published estimates of the size of this gap, looking at the legal sector only. The gap grew from $29 billion in 1974 to $62 billion in 1980," and you estimate it to be $92 billion by 1986. When you say "legal sector only," and you say, "those not associated with criminal activities and drug trafficking," is this a gap of people who are simply not paying taxes owed?

Commissioner EGGER. Right. We are talking, when we say the "legal sector," we mean income from legal sources.

The CHAIRMAN. Yes, I understand.

Commissioner EGGER. That is to say, not income from criminal activities.

The CHAIRMAN. From illegal sources. Oh, I see. So, in your judgment this is money owed that they are illegally not paying. It comes from legal sources, they just are illegally not paying the money?

Commissioner EGGER. That is correct.

For example, out of that gap, some $50-plus billion of it is just unreported income, just income that doesn't get reported and should have been.

The CHAIRMAN. Right. I got that.

A last question. From time to time, the idea of a tax amnesty program is brought up. Do you have any comments on the merits of that?

Commissioner EGGER. Well, I am on the record as having said that I don't think any tax amnesty is appropriate at the Federal level, for a whole long list of reasons. No. 1, the areas where amnesty has been the most successful are areas where there was a very inefficient or perhaps ineffective tax compliance program, where the laws didn't make tax cheating much of a crime, et cetera. And so I think that, given the effective compliance program that we have had at the Federal level regularly, particularly in criminal prosecution and so on, I don't think that we would produce the same results that one or two of the States have.

No. 2, I think that there is a very definite taxpayer perception here, that if the taxpayers who went along for years and didn't pay their tax and suddenly get off scot-free, that may be counterproductive in the sense that that could come back and haunt us.

And then finally, I am just not satisfied that we could get by with doing it once and then nevermore again. I have discussed this with one of my counterparts from outside the United States a couple of years ago, and I asked him if they had a tax amnesty program, and he said, "Oh, my, yes. We have one every 5 years."

The CHAIRMAN. Which only encourages waiting for it.

Commissioner EGGER. Right.

The CHAIRMAN. Max.

Senator BAUCUS. Mr. Chairman, thank you.

Mr. Egger, you may have gone over this, and I apologize. I, too am concerned about the compliance problem, all of us are. In a certain sense, without carrying the point too far, countries are not defeated by outside miliary sources, generally they are defeated by internal decay. And while the compliance problem is certainly not that far, it is a concern.

Will this proposal encourage more compliance? Do you think it will? We hope that it will. Can you tell us more precisely why you think it will?

Commissioner EGGER. I think the compliance, among other things, is the direct result of taxpayer perception. A couple of years ago we had a 3-day seminar on taxpayer compliance out in Reston. We brought in economists, tax lawyers, academicians, behavioral scientists, on and on, and it was perhaps one of the most intriguing 3 day discussions I have ever engaged in, looking at the whole question of why taxpayers comply or why they do not comply.

As an outgrowth of that, the American Bar Foundation has now funded a 3-year study on this whole thing, and I believe we will know a lot more about compliance then than we know now.

But I believe in this act the removal of what I call "the opportunity for tax sheltering," the elimination of the tax credit and all the other things I have mentioned in here, will go a long way to making it not very productive for people to go into shelters.

Senator BAUCUS. Some tax practitioners have volunteered to me that they don't think that's true. Just looking at the proposal, broadly it does not simplify things greatly for middle- and upper-income payers, those who itemize. There may be fewer itemizers, but it seems to me those who itemize still face complexity. I think for businesses and for the middle and upper income, it will be just as complex if not more complex. At least, that is a present widespread perception. And if that is the public perception when all is said and done, then what have we gained? There would still be an awful lot of complexity in the code. Those who do not itemize would think the others who do itemize, still are getting away with something they should not be getting away with.

So I just don't know if the compliance problem is going to clear up all that quickly.

Commissioner EGGER. Well, I think the design of this whole appraoch is exactly contrary to what you have suggested, in that this is not a case of making more opportunity available for people to "game the system," if you will, but of significantly less. When you combine that with the decrease in the marginal rates, I believe you have gone to two of the most important factors in the whole compliance world: One is perception, and the other one is——

Senator BAUCUS. I hope you are right. I think simplicity has something to do with compliance. Secretary Baker 2 nights ago said that simplicity was at the bottom of the list, that of the three principal goals.

One other quick question here, on revenue neutrality: People will mine and farm the code as best they can. Everyone wants to get his income tax lowered as much as possible. The estimates are based upon static estimates. It seems to me that people, once the changes take place, are going to take the then-existing tax law and do their very best to minimize their income taxes, and they will find some imaginative ways to do it, which is going to lower the revenue below expectations.

A good example may be the principal-home interest deduction. Why won't people refinance their homes to take advantage of that? They are going to get second mortgages.

I think the Service is going to have a hard time writing regulations to address that, if it to intent. How are you going to determine intent? There are all kinds of ways to channel money.

So I just wonder, given your position as Commissioner, and you know this code better than anybody, are we going to have revenue neutrality, or are we going to have revenue loss?

Commissioner EGGER. Well, my own observation as far as neutrality is concerned obviously has to depend on the forecasting done by the Office of Tax Analysis in Treasury. And my confidence in them is very, very high. So I am quite satisfied in that respect.

As far as people taking the new system and gaming it, of course there will be some of that. But in terms of refinancing homes, I can't believe that massive numbers of taxpayers are going to run out and risk their homes to get into some kind of a flaky tax shelter scheme of some sort. You know, I just don't see that happening. I really don't.

Senator BAUCUS. They might not do that, but they could refinance and get the interest deduction, and take that money and do something else with it. It would not have to be a risky venture.

Commissioner EGGER. We still limit it to the value of the home in the case of each taxpayer.

Senator BAUCUS. Well, you know America—10 percent down. Or for those frugal Americans who put 50 percent down, "What the heck, I think I'll take advantage of this and refinance it. I could use the cash." Anyway, I wanted to bring this up.

I have no more questions to ask, Mr. Chairman.

The CHAIRMAN. Mr. Commissioner, you have been most helpful. Thank you very much for taking so much time with us.

Commissioner EGGER. It has been a pleasure to be here, Mr. Chairman.

[Whereupon, at 11:52 a.m., the hearing was concluded.]

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